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S. HRG. 99-406, PT. I

DEPOSIT INSURANCE REFORM AND RELATED SUPERVISORY ISSUES

ORIGINAL

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON

THE SUBJECT OF DEPOSIT INSURANCE REFORM AS WELL AS THE NECESSARY RELATED SUBJECT OF FINANCIAL INSTITUTIONS SUPERVISION AND TO DETERMINE THE PROBLEMS AND STRENGTHS IN THE CURRENT STRUCTURES

PART I

JULY 23, 25, 31, SEPTEMBER 10 AND 11, 1985

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U.S. GOVERNMENT PRINTING OFFICE

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WEDNESDAY, SEPTEMBER 11, 1985

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DEPOSIT INSURANCE REFORM AND RELATED SUPERVISORY ISSUES

PART I

TUESDAY, JULY 23, 1985

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 9 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, D'Amato, Mattingly, Hecht, Proxmire, Cranston, Riegle, Dixon, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

This morning we are commencing the first in a series of hearings on the subject of deposit insurance reform as well as the necessarily related subject of financial institutions supervision.

The deposit insurance system we now have has been in force since 1933 with few significant changes. While the system has worked very well for over 50 years, the changes that have occurred recently in the industry truly have been revolutionary.

Therefore, we should reconsider the assumptions behind the deposit insurance mechanisms and funds and reexamine the systems now in place to determine how well they function in today's environment.

The idea of reviewing the system is not new. In the Garn-St Germain Act, FDIC, FSLIC, and CUSIF were directed to study the present state of the law and inform Congress on whether changes were needed. Their efforts culminated in reports which were combined and printed by this committee and the House Banking Committee in June 1983.

In line with the reports, in the 98th Congress legislation was passed which provided for recapitalization of the Credit Union Share Insurance Fund. That recapitalization is virtually complete and, as a result, the insurance fund has been increased by $1 billion, raised from the industry itself.

Recent events have underscored further the need for a congressional reexamination of deposit insurance. I emphasize that all that we are embarking on here is a reexamination. I come to this issue with no preconceived ideas and to the best of my knowledge neither do my colleagues on the committee. We are here to ask questions and to determine the problems and strengths in the current structure.

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In addition to the report prepared pursuant to Garn-St Germain, a great deal has been written on this subject by lawyers, economists, accountants, and academics of almost every stripe. I think it is fair to say that no consensus has emerged from the studies of the writings to date.

These are extremely complex and difficult issues. While virtually everyone agrees that the ultimate goal is the stability of our financial intermediary system, there are a myriad of issues that underlie that goal. How well are we able to determine the condition of insured institutions? Would greater public disclosure produce market discipline or simply lead to runs? Should we move to a system of risk-based deposit insurance premiums or should we continue with the present flat rate premiums which operate more like a group insurance plan? Should we have a system of risk-based capital levels? Should capital standards also be applied to off-balance sheet liabilities?

In addition, there are a number of interindustry issues that must be considered. Are all institutions, regardless of size, treated the same under the present regulatory system? When should an institution be allowed to fail and should that decision be made to reduce risk to the deposit insurance fund insuring it or based on the needs of the community it serves? Should regulators have greater authority to direct the affairs of institutions which are solvent which appear to be on the verge of failure? How can we conduct the due process rights of shareholders and management while giving regulators greater authority?

Not least important are issues of federalism. We now have a system where identical insurance premiums are paid by all institutions of certain classes regardless of the powers extended those institutions by their State governments. In this context, there is also the issue of what role, if any, remains for other kinds of insurance?

As I said earlier, I come to these hearings without predispositions. I have raised here only a few of the issues which it seems to me should be considered. Obviously, the broad issue of deposit insurance reform is one that will require a great deal of congressional time and deserves regular study. I anticipate that the hearing today will be only the first of several on various aspects of the review of the system.

We are fortunate to start these hearings with witnesses who have some real expertise and experience in this area. We also have some here that have fairly definite opinions.

First, I welcome Chairman Isaac of the FDIC, and he fits in that category of having definite opinions. He will be followed by Joe Selby, Acting Comptroller of the Currency. We then have a panel of financial institutions experts consisting of David Cates, president of Cates Consulting Analysts, Inc., in New York; Harry Keefe, chairman of Keefe, Bruyette & Woods of New York. Our second panel brings with them comprehensive knowledge of the recent history of the issues under consideration here and it will include Paul Homan, former Senior Deputy Comptroller for Bank Supervision; John E. Ryan, former Director, Division of Banking Supervision and Regulation for the Federal Reserve; and Thomas A. Brooks, former general counsel of this committee and former general counsel of the FDIC.

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The third panel will include some of the many academics who have studied deposit insurance systems. Today we will hear from Prof. Edward Kane, Reese professor of banking and monetary economics at Ohio State University; and Prof. Paul Horvitz, Judge Elkins professor of banking and finance at the University of Houston.

After each of these witnesses presents his oral testimony there will be questions from members of the committee, except for the empaneled witnesses, the questions will follow the presentations of all of the members of the panel.

We have received written testimony from each witness and these written testimonies will be included in the record in full and I would expect that we would also have additional questions for response in writing from the witnesses.

I am very happy to welcome all of the witnesses here today.

Senator Proxmire, do you have any comments you wish to make?

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Thank you, Mr. Chairman.

Mr. Chairman, first, I commend you for moving on the important topic of deposit insurance reform.

For the last 2 years we have been excessively preoccupied with issues of competitive equity, level playing fields, product deregulation, and the like. While these subjects may be of intense interest to the financial trade associations in Washington, they have little meaning for the average family in Milwaukee or Salt Lake City.

Most of the people I've talked to about banking are concerned about one thing--safety. They want to know that their funds are secure.

I have no doubt that the vast majority of banks and savings and loan associations are in sound condition. Nevertheless, there has been widespread public concern over recent failures of banks and thrift institutions. This concern highlights the fact that it is the Congress—the Congress—that is the ultimate guarantor of financial solvency and that our most important responsibility is to maintain the safety and soundness of our financial system.

I'm very impressed, Mr. Chairman, with the panels you have called and I've had a chance to go over the statements of the witnesses and I think they are very impressive--they are also delightfully contradictory. We should have some interesting battles this morning because there are some assertions that certainly sharply conflict.

Because you have these distinguished witnesses to appear, I'd like to make just four brief points:

First, while our nominal subject is deposit insurance reform, we are really talking about our entire system of banking and thrift regulation.

Second, many of the problems we will discuss stem from our existing regulatory framework which divides authority among three bank regulatory agencies and a fourth agency for regulating savings and loan associations. As I have pointed out many times in the past, this is the only industry that has so many competing and varied regulators. Instead of one, we have four.

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As we get deeper into deposit insurance reform we will find that it cannot be divorced from structural reform.

Third, deposit insurance reform is clearly related to further deregulation of banking services. Right or wrong, many Members of Congress will be skeptical of allowing banks to expand their activities unless they are convinced we have a stronger regulatory system in place.

Fourth, if banking deregulation is to be linked with deposit insurance reform, it becomes even more urgent to close the nonbank bank and other loopholes in our banking laws as soon as possible.

There is a broad consensus in both the House and Senate that these loopholes should be closed promptly. We should not delay further on this relatively simple issue while we tackle the infinitely more complex issue of deposit insurance reform.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Proxmire.

Senator Hecht.

Senator HECHT. No statement.

The CHAIRMAN. Senator Dixon.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the Banking Committee begins its series of hearings on deposit insurance and related supervisory issues. We have a distinguished group of witnesses before the committee today. I always appreciate the opportunity to hear from the distinguished Chairman of the Federal Deposit Insurance Corporation, Bill Isaac, and to have the benefit of the views of the Comptroller of the Currency. I would particularly like to note the presence of Paul M. Homan, former Senior Deputy Comptroller for Bank Supervision, and to point out that he is now with a major Illinois financial institution, Continental Bank.

A number of deposit insurance issues have arisen in recent years, and I believe the review of these questions and supervisory concerns is essential. As we begin our review, however, it is worth noting just how successful deposit insurance has been. This Depression-era reform was probably the single greatest factor in restoring consumer confidence and building the strong, stable banking system that has so benefited this Nation over the past 50 years. Deposit insurance worked, and worked extremely well.

The financial structure put in place during the thirties, however, is changing rapidly as our economy and marketplace changes. Banks have new competitors, and new competitive pressures to respond to. Interest rate deregulation is now the law of the land. In short, the banking industry is in a period of fundamental change.

There are those who advocate changes in our deposit insurance system as necessary to respond to these changes, or perhaps even to promote further change. These hearings are the beginning of the Banking Committee's consideration into whether and what kind of change is necessary and desirable. I come to these hearings with an open mind. I am grateful to have this opportunity to explore deposit insurance-related concerns in greater depth, and I look forward

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to working with this morning's witnesses and with all interested parties as that process continues.

The CHAIRMAN. Senator D'Amato.

STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Good morning, Mr. Chairman. Today this committee will examine the Federal Deposit Insurance System in this Nation. Before we begin, however, I would like to welcome our distinguished panel of witnesses. I appreciate their taking time from their schedules to testify today. The soundness and stability of the Federal Deposit Insurance System is of great importance to all of us concerned with the banking industry. I hope this hearing will provide an appropriate forum for discussion of this system.

Over the past year, the Federal Deposit Insurance System has become the center of concern for several reasons. Banks, both large and small, have been failing across this Nation at an alarming rate. This high bank failure rate has raised serious questions about the adequacy of the examination process, enforcement actions, disclosure requirements, and methods of assessing deposit-insurance premiums and whether the FDIC and FSLIC fund is large enough to adequately protect the industry.

Bank failures have become all too common these days. These failures and the transactions that precede the failures give us a strong message: the Federal Government must toughen the enforcement of its guidelines for banks to follow.

Questions have to be answered. There is definite need for the public to have confidence in the deposit insurance system's ability to maintain a safe, equitable, and stable financial system in this Nation. It is my sincere hope that this committee will answer all the pertinent questions facing the industry. These questions can only be answered with your help and knowledge.

Thank you, Mr. Chairman.

The CHAIRMAN. Chairman Isaac, last time you were here we all eulogized you. It was so complimentary it was almost like your funeral speeches, and we——

Senator PROXMIRE. We thought it was your last appearance.

The CHAIRMAN. We thought it was your last appearance. So rather than do that again because this probably is your last appearance, we may just end up having that record reprinted again. In any event, we are happy to have you here and please proceed.

STATEMENT OF WILLIAM M. ISAAC, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. ISAAC. Well, Mr. Chairman, I have found that old regulators, unlike old soldiers, neither die nor fade away, but it's a pleasure for me to be here. It's a real privilege to lead off this series of hearings on deposit insurance reform and related supervisory issues.

The CHAIRMAN. Thank you very much, Mr. Chairman.

As I said in my opening remarks, I have no preconceived ideas of where we should be going, but one I have over and over again suggested is that we look very closely at risk-related premiums, and I think you pose a very good question—should the well-run institution subsidize or pay for those that are not.

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One of the arguments that is made again is that since a significant number of banks failures are caused by fraud, some would say, therefore, in those cases, risk-related premiums would be totally ineffective.

What is your opinion on that?

RISK-RELATED PREMIUMS

Mr. ISAAC. Well, risk-related premiums would not catch every case of fraud. But there are many banks in which fraud is found that prior to the fraud you find other troubles in the bank which would cause the bank to be in a higher risk category. No system of risk-related premiums is going to be perfect and is going to catch every situation that it should catch, but we will be able to catch most of them. Certainly any system we devise for risk-related premiums is going to be more fair and equitable and less arbitrary than the present system, which is completely unfair and completely arbitrary and makes no attempt to distinguish among institutions.

The CHAIRMAN. Well, I would agree with you. No system is going to be perfect.

Don't you feel that in most cases of fraud that it would still be a better system than what we are dealing with now?

CAMEL RATINGS

Mr. ISAAC. Yes, I do. Let me give you some statistics just to give you an example. I've seen articles about our capital assets management earnings liquidity [CAMEL] rating system and how reliable is it in predicting failures and the like.

Senator Gorton recently asked us to provide some information on our CAMEL rating system. We submitted information to Senator Gorton which showed that of the 79 closings that occurred last year, 100 percent of those institutions were rated 3, 4, or 5. Those are the troubled banks—100 percent of them were rated 3, 4, or 5 as of the last exam prior to their failure.

If you go back to the exam previous to that, 95 percent of them were rated 3, 4, or 5. If you go back to the exam prior to that, 77 percent of them were rated 3, 4, or 5.

Looking at this year, we had 44 failures through June 11: 100 percent of them were rated 3, 4, or 5 on the date of failure. And 98 percent of them were rated 3, 4, or 5 on the previous exam and 82 percent of them were rated 3, 4, or 5 on the exam previous to that.

So I would say we have a highly reliable system for classifying bank risks.

The CHAIRMAN. One of the arguments made against risk-related premiums is the very thing you're talking about here—how you decide who goes into which category and if the information gets out are you then causing runs because the depositors find out, well, my bank is paying more premiums? How do you answer those kinds of criticisms?

Mr. ISAAC. Well, I've heard those kinds of criticisms about every move we have tried to create some kind of discipline in the system.

For example, when the SEC a decade or so ago decided to require public disclosure on nonperforming loans and the like, the banking

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industry contended it would cause havoc and there would be runs left and right. That did not occur.

Now, 2 or 3 years ago, the banking agencies decided to include nonperforming loans and other kinds of information in the call reports and make it available to the public and the banking industry contended that that would cause runs on institutions. It did not.

More recently, we decided to publish enforcement actions and we heard the same contentions.

I think those concerns are grossly overstated, No. 1. Second, I don't believe that the disclosure of the risk-based premium system would be traumatic. The system we have proposed would use objective formula. The information would be taken right off of published call reports available to the public. Anybody could sit down and calculate the premium. I can't believe that would create any serious problem.

The CHAIRMAN. Well, I remember when we talked about the additional disclosure I had many bankers come to see me and say, "It is all right with us. I think it's a good idea, as long as you don't impose it for 6 months to a year." And I said, "Well, what that means to me is that you want to clear up a lot of bad loans before you have to disclose them." They would say, "That is not what we said." And I said, "Yes, that is exactly what you said." They want to clean up their act before the disclosure took place.

I would wonder if we might have some of the same reaction of people. It's all right as long as we clean up our act before we start having to pay the additional premiums. I think just putting it into effect may have a salutary impact on some operations.

Mr. ISAAC. That is a very good point. I couldn't agree more. The best protection that a bank has against adverse disclosure is not to have the problems that lead to the disclosure.

The CHAIRMAN. Do you think we made a mistake when we increased deposit insurance to $100,000. Both Senator Proxmire and I were involved in that and at the time, because of lack of confidence in the system, we felt that that was very helpful. By raising it to $100,000 have we created some operations that are not as safe as they otherwise might have been because they take the attitude, well, people are insured up to $100,000 and we can take certain risks and be involved in certain activities which we would otherwise maybe be more careful about?

Mr. ISAAC. Well, as you know, Mr. Chairman, at the time the limit was raised from $40,000 to $100,000 the FDIC opposed it, believing that it would undermine discipline in the system.

Yes, I believe it was a mistake. At the same time, I believe we are stuck with it. I don't believe we should try to roll it back.

The CHAIRMAN. Well, I would agree. I don't think it's possible to roll it back. On the basis of hindsight, I certainly would not agree with increasing it. But politically, you're not going to take it back. I suppose in hindsight a more moderate increase, rather than jumping all the way from $40,000 to $100,000, would have been proper. But I plead guilty to thinking it was a very good idea at the time and never cease to be amazed at how good hindsight always seems to be.

Senator Proxmire.

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CATES SYSTEM

Senator PROXMIRE. Mr. Isaac, you're being followed by a very capable critic, Mr. Cates, and I'd like to give you a chance to answer a challenge that he throws down. This is in response to what you just told us about the CAMEL ratings.

He says:

The research studies shows that only 37 percent of the banks that later failed in 1981–83 rated 4 or 5 in the year prior to their failure. Only 22 percent were rated 4 or 5 in the next to last year before failure. The record is not very reassuring. Not only does it call into question regulatory ability to anticipate failure, but it appears also to undermine the validity of the problem list, the size of that list, its trend, and the specific makeup of the list.

Then he goes on to say this—and I'd like your comment—he says:

To further this explanation, our firm in effect challenges the regulators to a duel in analytic technique, with this committee and the public as the beneficiaries of the outcome. Our grounds for throwing down the gauntlet are that we, too, operate a bank-risk rating system that parallels the CAMEL system except that our method, unlike CAMEL, is based entirely on quantitative, remote financial analysis of banks and bank holding company ratios. Here is how we classify the 75 failures of 1984 for which we had 1983 financial data. There were 79 failures in total. 92 percent of these failures fell into our 5 category prior to their failure.

Now that it seems to me to be a pretty interesting challenge and I'd like to have your response.

Mr. ISAAC. Well, I would make several responses. First of all, the data he cites were collected in the 1981–83 period and I believe that substantial improvements have been made in our system since that time which the statistics I gave you earlier demonstrate. Now, 100 percent of all the banks, not 92 percent, were rated as 3, 4, or 5 prior to the failure.

Senator PROXMIRE. He included 5. He had 92 percent in 5.

Mr. ISAAC. But I think you must include 3-rated banks. A 3-rated bank is a bank that has an inordinate amount of risk, higher than the normal sort of problems, and requires close supervisory efforts. Approximately 15 or 16 percent of the banks are rated 3, 4, or 5. Those are the banks that we target for increased supervision. We believe they have a higher than normal risk of failure. So you must include the 3-rated banks in any analysis.

If you go back 1 year before the exam, we were in the 95 to 98 percent range. If you go back to the exam previous to that, you're talking about 77 to 82 percent success rating in identifying these.

Also, I can develop a system very easily that will identify every troubled bank. The problem is getting a system that identifies every troubled bank without also identifying 4,000 other banks.

The FDIC has the ability to identify 100 percent of the troubled banks in an off-site monitoring system. The problem is getting an off-site monitoring system that does not also identify 4,000 or 5,000 other banks as troubled. I don't believe the Cates system works very well in that respect.

Senator PROXMIRE. Are you familiar with the Cates system enough to tell me what proportion of the banks he would categorize as No. 5? He says 92 percent of the failures fell into our No. 5 category. That's a whale of a lot better than the FDIC record that only 37 percent of the banks rated 4 or 5.

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Mr. ISAAC. Well, Senator Proxmire, I just said that he's using, No. 1, old data and the system has been substantially improved. No. 2, you cannot just look at 5-rated banks. You have to look at 3-, 4-, and 5-rated banks.

Senator PROXMIRE. For the record, will you tell us in what respect the system has been improved substantially? Not orally now, but for the record?

Mr. ISAAC. Sure.

Senator PROXMIRE. It's my understanding that Martin Van Buren in his administration in the 1830's proposed Federal deposit insurance. It took us almost 100 years to enact it.

Do you think it will take us that long to reform it?

Mr. ISAAC. I hope not. Senator Proxmire, might I also just add one other thing about this question you asked about the Cates system?

COOPERATE WITH PRIVATE VENDORS

We work with private vendors all the time, including David Cates, Keefe-Bruyette, and other firms that are in this field, plus academics and the like. We would be more than happy at any time to sit down with anybody and try to learn from their system.

But I would tell you, in the end, I have total faith in the FDIC professional staff. There is no other group of people in the country that knows more about problem banks and bank failures and I will rely on them to provide the judgments about which banks need more supervision and which ones don't.

Senator PROXMIRE. Now your testimony reveals that our bank regulatory system could be considerably stronger were it not for dividing authority among three banking agencies and one agency to regulate savings and loan associations. For example, you say that higher capital standards could be implemented administratively but because of disagreement among the agencies that does not appear likely in the absence of congressional direction.

Isn't this another example of the competition in laxity that Arthur Burns warned about over 10 years ago and doesn't it indicate that we need to at least consolidate the three banking agencies into one independent agency as I have advocated over the years?

Mr. ISAAC. I don't believe that you have the competition in laxity in the system that Arthur Burns warned about or before him Marriner Eccles. I don't believe there's forum shopping that's permitted in order to avoid enforcement actions and the like. If one regulatory agency is taking an enforcement action against a bank and the bank tries to jump charters to another regulator, I believe there is plenty of follow-up by the other regulator.

I do think that our present system of bank and thrift regulation is unwieldy. I think we have too many regulators. And though I wouldn't go to a one-regulator system, I think that we have to substantially streamline the system.

Senator PROXMIRE. Why not go to a one-regulator system? Every other industry in America that has regulation, by and large, has a single Federal regulator.

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Mr. ISAAC. First of all, I have some concerns about the dual banking system and how you preserve that in a one-regulator system, though I think you might be able to overcome those problems.

One of the big concerns I have is that I think having the insurance agency apart from the principal regulator is very, very healthy. It's a check on the regulator. I think it's extremely important to have the insurance agency sitting out there bird-dogging the problems, second-guessing the regulator. I wouldn't want to develop a system where the insurance agency and its funds were placed at the disposal of the primary regulator who could choose to ignore problems instead of dealing with them.

Senator PROXMIRE. Well, if we're unable or unwilling to consolidate the three bank regulators into one, we could at least give one agency the exclusive authority to set capital standards for insured banks. Since the FDIC bears the ultimate financial responsibility for bank failures, why shouldn't you, the FDIC, have exclusive responsibility to set capital standards? In particular, why should the Comptroller of the Currency have any authority over capital standards when it bears no financial responsibility if a bank has inadequate capital?

Mr. ISAAC. Well, the Bush task force, as you may recall, Senator Proxmire, has recommended that the FDIC and the FSLIC be directed by the Congress to set uniform minimum capital standards applicable to all insured banks and thrifts. We support that measure.

Senator PROXMIRE. You support that. Good.

As you know, I introduced an amendment to last year's banking bill to include foreign deposits in the FDIC premium base. As you point out in your testimony, many of the large money center banks have half or more of their deposits in their foreign branches and pay no premiums against these deposits even though they are 100 percent de facto insured by the FDIC.

One of the arguments raised against this proposal is that it would put our large banks at a competitive disadvantage against foreign banks.

How do you respond to that argument?

PRESENT SYSTEM IS UNFAIR

Mr. ISAAC. First of all, I believe the present system is patently unfair. Take Citibank and Bank of American which are roughly the same size, Citibank paid less than half the premiums last year that Bank of American paid, that's unfair. Thousands of smaller banks around the country are paying FDIC premiums on their entire deposit base, while the bigger banks are avoiding payment of premiums on half of their deposit base; that's unfair.

We have got to straighten out that system. One way to do it would be to try to find some way of exempting foreign deposits from de facto insurance coverage because every time a big bank has gotten into trouble we have bailed out the foreign depositors. So they have had coverage.

Senator PROXMIRE. That's right.

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Mr. ISAAC. One way to try to straighten out the system would be to exempt those foreign deposits from any kind of coverage. I don't know how to do that. I don't think we're going to find a way. If we can't find a way, then I think we have to assess the deposits and make it fair. If the big banks are operating at such a spread that one-fifteenth of 1 percent minus rebates makes that big a difference, then they ought to get out of that line of business.

Senator PROXMIRE. My time is up.

The CHAIRMAN. Senator Hecht.

Senator HECHT. No questions, Mr. Chairman.

The CHAIRMAN. Senator Dixon.

Senator DIXON. I have no questions, Mr. Chairman.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

PROPOSING MERGER OF BOTH FUNDS

Bill, you are proposing that the FSLIC and the FDIC merge. As you know, the FSLIC has some reservations about that.

If you were in Ed Gray's shoes, what would you say were his most legitimate objections?

Mr. ISAAC. Well, one objection that people from each industry seem to have is that they don't want to pay for the problems in the other industry. We propose overcoming those objections by computing the assessments for deposit insurance on a separate basis for each industry for a period of years after the funds are merged. Only after we have completely phased in uniform capital and accounting and disclosure rules and have the two industries on a comparable footing, would we unify the assessment system. Until then, we would run it on a separate basis.

I think another concern Ed Gray has expressed is that he believes their system is more efficient in the sense that the insurance agency, the provider of liquidity in the form of the Federal Home Loan Bank System, and the regulator are all in the same house together and they can work more efficiently together in dealing with problems. I don't believe that's true.

While the commercial bank system, where we have the regulators, the insurer and the central bank apart from one another, is frustrating, it has worked extremely well and efficiently in handling problems. I don't believe that the system that the Bank Board has operated under for the past several years has performed any more efficiently or more effectively in dealing with the large number of problems than has the commercial bank system.

Plus, I believe that there are some checks built into the system where you separate the agencies. You can't cover up problems when you've got the insurer sitting out there apart from the regulator, second-guessing it. You have to deal with problems when the insurer wants to deal with them. The insurer's interest is in solving problems and not sweeping them under the rug. So I believe there are some checks built into it.

Senator HEINZ. Do you see that as a problem with the FSLIC today? Are they sweeping problems under the rug?

Mr. ISAAC. I believe that the——

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Senator HEINZ. It seems to me that everybody is in under the rug with them looking at the problems, if that's the case.

Mr. ISAAC. I believe that a merged fund, a stronger merged fund, would be dealing with problems differently than they are being dealt with today in the thrift industry. The problems would be addressed. We wouldn't have as many insolvent institutions limping along increasing the exposure to the insurance system.

Senator HEINZ. Do you believe that the lack of reserves in the FSLIC compared to what you have is resulting in regulatory laxity? Is that what you're saying?

Mr. ISAAC. I believe, of necessity, it is requiring the Bank Board and the FSLIC to avoid confronting some situations that they should confront.

Senator HEINZ. Whereas——

Mr. ISAAC. I'm not being critical. I said "of necessity" they are avoiding them.

Senator HEINZ. I understand you're not being critical. I think we all understand what the problems are in that industry and relative to the size of the reserves of the FSLIC.

Would you think that if we did not, for whatever reasons, merge the two funds, that there would be some other methodology available to us for allowing the FSLIC to strengthen its financial position and thereby strengthen its regulatory ability?

Mr. ISAAC. There are only two ways I know of to strengthen the FSLIC apart from a merger of the two funds. One is to assess the insured institutions at a higher rate.

Senator HEINZ. And there have been, as you know, continuing discussions about that.

Mr. ISAAC. I believe that would ultimately be very counterproductive.

Senator HEINZ. Why?

Mr. ISAAC. No. 1, it weakens the institutions more by causing them to bear a much higher price for deposit insurance than they can afford. But more of a problem than that, the best institutions in that industry are going to have a tremendous incentive—if you assess them at a higher rate and continue it for a prolonged period of time—to leave the FSLIC system. They are going to convert to commercial bank charters and join the FDIC system. So what you're going to wind up with is an FSLIC system in which the only members are troubled institutions.

So I think that option is not going to work for very long.

The second option is to appropriate taxpayer money and I am adamantly opposed to that unless it's absolutely vital. I don't believe it is. I believe that the FDIC can, when you merge the two funds together, handle the problems that exist in the S&L industry in an orderly way without requiring one penny of taxpayer money.

Senator HEINZ. Why can't the——

Mr. ISAAC. Barring a dramatic runup in interest rates. Then you have another problem.

Senator HEINZ. Why can't the premiums to shore up the FSLIC from their existing base be risk-assessed as you propose for the FDIC? Are the financial institutions that are troubled just too weak to bear that?

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As I've looked over those numbers, it seems to me that in for a penny, in for a pound. You're talking about exposures that are so large that it's hard to imagine how a premium would make them all that much larger.

RISK-RELATED PREMIUMS FOR S&L'S

Mr. ISAAC. Well, there are a couple problems. I don't have any problem with risk-related premiums. I think they are desirable. But if you're talking about raising a lot of additional revenue, there are problems with it. If the revenue is coming from the insolvent firms, all you're doing is taking it out of one pocket and putting it into another. You're just increasing the degree of insolvency you have to deal with. If the increased revenue is coming from the good firms, they're going to leave the system and join the FDIC system.

Senator HEINZ. It's kind of a catch-22, and yet what you propose in a sense is that the banking industry subsidize the S&L industry in a merger.

Mr. ISAAC. No.

Senator HEINZ. What's the difference between doing that and using taxpayer money?

Mr. ISAAC. Barring a dramatic runup in interest rates, our studies show that the merged fund can handle the problems without assessing commercial banks any additional cost.

Senator HEINZ. I understand that. That's because the price has already been assessed, isn't it? It's already in the fund.

Mr. ISAAC. Our studies also show that the FDIC fund, again barring a runup in interest rates, would never decline in size. It would go down as a percentage of insured deposits, but it would not go down in terms of aggregate dollars. We would not need to tap the fund.

The biggest reason for it is the fact that we have a very substantial assessment base. Most of the institutions are not experiencing problems. And we have a very large portfolio of Government securities which produces rather substantial amounts of interest income.

Senator HEINZ. So to sum up your position—and let me know if I'm misstating it—you say the FSLIC and the FDIC in one sense don't need to merge as long as there's no runup in interest rates because there will always be a positive balance in the FSLIC fund—it will always be substantial—but if there is a big runup in interest rates, there won't be enough in the FSLIC and therefore it's a good idea to merge?

Mr. ISAAC. No, I'm sorry.

Senator HEINZ. Is that the essential logic or did I miss something?

Mr. ISAAC. No; I must have misstated it because I believe that even barring a runup in interest rates, a merger of the funds is needed in order to resolve the S&L problems.

Senator HEINZ. I thought you said—and correct me if I misheard you—that if you did merge the two funds, the FSLIC portion of those funds would always have a positive balance.

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Mr. ISAAC. No; I said the combined fund would always have a positive balance.

Senator HEINZ. Combined fund. I'm sorry. I misunderstood you.

Mr. ISAAC. That is correct. The combined fund would have a positive balance, not the FSLIC portion of it.

Senator HEINZ. That assumes that the regulators would get tougher.

Mr. ISAAC. As a precondition for any merger of the funds, the FDIC would want to see Congress mandate uniform capital accounting, and disclosure rules for banks and thrifts. That is essential.

Senator HEINZ. And things such as net worth certificates and all that would cease to exist either quickly or phased out over a period of time?

Mr. ISAAC. Certainly they should be phased out.

Senator HEINZ. All right. My time has expired. Thank you, Bill.

The CHAIRMAN. Senator Sasser.

INCREASE OF SMALL BANK FAILURES

Senator SASSER. Chairman Isaac, there were 79 bank failures in 1984 and 75 percent of them had deposits of $30 million or less.

Now the percentage of troubled banks from the ranks of the smallest institutions had increased in 1984 from 1983. As I understand it, only 60 percent of the failed banks in 1983 had deposits of $30 million or less.

And I'm concerned about what's happening to the smaller community banks. What's the profile of the banks that are currently on the troubled list? What percentage would you estimate are under the $30 million level?

Mr. ISAAC. I would have to give you those numbers in a followup to be precise, but to give you a general idea, I would say that the vast majority of banks on the problem list are smaller banks. There's a large representation now by agricultural banks located primarily in the Midwest.

Senator SASSER. And if you would characterize or profile these banks, are these primarily small banks engaged in agriculture-related loans?

Mr. ISAAC. Approximately one-third of the banks on our problem bank list are smaller banks engaged in agricultural lending.

Senator SASSER. Let me ask you about something we have wrestled with in this committee for some time. What is the future of small community banks in this country, in your judgment?

Mr. ISAAC. I don't have any concern about the smaller banks and their future in this country, assuming that we make the regulatory system and the deposit insurance system fair.

When I came to the FDIC in 1978 there was a gross discrimination in the regulatory system against smaller banks in the form of disparate capital requirements. Small banks were required to maintain 7 or 8 percent capital ratios and the bigger banks were down around the 3-percent level. That was unfair and if it had continued in a deregulated environment, it would have driven small banks out of business. They simply couldn't compete. So we corrected that inequity.

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The deposit insurance system is unfair. By exempting foreign deposits from assessments, it's charging small banks proportionately more than the larger banks. That must be changed. There's a perception that depositors in small banks will not be made whole in every case while in big banks they will be. That's unfair.

If we can change those kinds of inequities in the system and rectify them, then I believe that the future of the small bank is bright. The banks that will make it in the new world will be the well-run banks of whatever size and the banks that will go by the wayside will be the poorly run banks of whatever size. That's the way the system should operate.

Senator SASSER. I'm advised that there are 1,100 banks on the problem list at the present, give or take a few on either side of that figure. As I recall, the last time you appeared before this committee you indicated that there were 949 banks on the problem list. We've got an increase here, if my rudimentary arithmetic is correct, of anywhere from 12 to 15 percent.

Mr. ISAAC. Maybe before you get to your question I can clarify the facts because the 1,100 figure is wrong.

Senator SASSER. It is wrong?

Mr. ISAAC. Yes.

Senator SASSER. What is the number?

Mr. ISAAC. It's probably closer to 1,000.

Senator SASSER. Closer to 1,000. So if it is closer to 1,000, there has been a more modest increase from when you were last here.

Why are banks showing up on the problem list, in your judgment? Is it a result of bad loans, bad management, or are we still experiencing a fallout from deregulation?

Mr. ISAAC. I don't believe deregulation is the culprit at all, with the one notable exception, and that is the practice of money brokers taking funds, packaging them into fully insured parcels and dumping them off in troubled banks that pay the highest rates. That's one serious problem with deregulation that has to be addressed.

The principal cause for banking problems today is the economic climate we're in, coupled with bad management and fraud.

As a nation, we experienced more than a decade of accelerating inflation, which distorted investment and credit decisions by bankers and businesses, followed in the late seventies by a period of very high and volatile interest rates, two back-to-back recessions, the second the most severe in 50 years and now disinflation in sectors such as energy and agriculture.

Those problems are in the banking system now and they have not run their course. We expect the problem bank list to continue to climb this year and next. We expect the bank failure rate to exceed 100 this year and next. Then we'll see what happens.

Senator SASSER. So you would assign as the primary reason for the number of problem banks in the long-term economic problems that we have experienced over a period now of almost a decade?

Mr. ISAAC. That is correct. And if the Congress could do one thing to strengthen the financial system, even more important than deposit insurance reform, as near and dear as that is to my heart, it's to get——

Senator SASSER. It's to do something about the budget deficit?

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Mr. ISAAC. Get the deficits down.

Senator SASSER. Right. Well, I'm all in favor of doing that. I must say that's easier said than done, but we really need to do it. Mr. Chairman, thank you.

The CHAIRMAN. Senator Mattingly.

Senator MATTINGLY. I have no questions, Mr. Chairman. I just welcome Mr. Isaac to the hearing.

The CHAIRMAN. Chairman Isaac, you've indicated in your testimony today that throughout the history of the FDIC the most frequently used method of solving failed bank problems is through purchase and assumption transactions rather than just going in and paying out the insured depositors. And I assume this is because it's less disruptive for the community to do so and bank customers and, maybe even more importantly, less expensive for the FDIC.

I would assume that you would agree that this is still true today; that this is a preferred method of doing it. Is that the case?

Mr. ISAAC. Yes; it is.

The CHAIRMAN. And I assume will be in the future?

Mr. ISAAC. Well, that will depend a little bit on the course that's set for the future. If we try to find ways of obtaining more discipline in the system through depositors, then the purchase and assumption transaction is going to have to go by the wayside.

INCREASED MARKET DISCIPLINE

The CHAIRMAN. With regard to the need for increased discipline on bank managers and directors, you argue that swifter and surer enforcement action is part of the answer, but increased market discipline is the other half of the equation. And while you seem to equate market discipline with increased disclosure, others suggest that a regulatory use of market value accounting will produce faster recognition of problems by regulators.

Now if we turn to market value accounting and regulators were given the authority to require mergers prior to economic insolvency, would you feel this would be the ultimate discipline on officers and directors, fear of losing their jobs and prestige that goes with it?

Mr. ISAAC. I'm not opposed to market value accounting. In fact, I have struggled over the past several years to try to get some interest in it at the regulatory agencies, but it's an extremely difficult, complex subject. I'm not optimistic you will ever see a market value system. Perhaps there could be greater disclosure of market values in footnotes to balance sheets and the like.

But to convert to a true market value system is really troublesome. How do you mark the assets to market when there's not a clear market test? If you're going to mark the assets to market, are you going to mark the liabilities up to market or down to market as the case may be? And that gets into a series of debates that will last until the end of this century.

People who glibly say that we ought to go to a market value accounting system have not studied the issue very carefully. Even though I would love to see it, I can't figure out how to do it.

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The CHAIRMAN. I don't disagree that there are not problems in going that direction. What we're searching for in these hearings is, as you stated in your opening statement, some middle ground, some balance between the extremes. This may be going too far and something that takes too long.

Mr. ISAAC. If nothing else, I would like to find a way to mark the investment portfolio to market and have that accepted as standard practice. But we have found very little receptivity to even that limited approach.

The CHAIRMAN. But you would have to agree that it would certainly discipline poor management practices a lot more swiftly than we're doing it now?

Mr. ISAAC. Yes; it would.

The CHAIRMAN. And it would also facilitate the assisted merger route that we've been going?

Mr. ISAAC. Yes; it would.

The CHAIRMAN. We're all going to find out I'm sure as we start these hearings, that everybody agrees we ought to do something. That's my fear: that everybody is going to be in favor, but not action. So some of these questions I will ask as the devil's advocate. I do this so we can hopefully recognize that we don't have time to wait until the end of the century to argue about these types of issues. I'm stating that at the outset to remind people, who have their own pet ideas that if we are going to solve this problem, there is going to have to be some give and some take. Some of the extreme views are going to have to be moderated and we are going to have to come to some consensus, no matter how much differences of opinion we have at the outset. Everybody is so tickled with their own solution that we will not have a solution.

Mr. ISAAC. Mr. Chairman, we have struggled with these issues over and over and over again during the past 4 or 5 years at the FDIC. We have encountered unprecedented problems in terms of the number of banks on our problem list and watch list. We have handled an unprecedented number of bank failures. I think we know about as much about the problems in the banking system as anybody could know, and we have looked at every kind of solution. There is no one single thing that you can do, but when you talk about trying to provide some discipline in the system, the one thing that keeps on coming back to me is the 9-percent capital requirement, allowing it to be phased in over a period of years and allowing up to 3 percent of it to be met by subordinated debt so the market is pricing bank risk.

I was not in favor of it when our staff first came up with the notion 3 or 4 years ago. I argued against it. We had interminable debates. But I keep on coming back to that as probably the single most important and practical reform that could be made.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. I just have a couple questions because I realize we have a lot of other witnesses.

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AUTHORITY TO EXAMINE BANKS

Mr. Isaac, what authority does the FDIC now have to examine national banks or State-chartered member banks if it has reason to believe they are not being soundly managed?

Mr. ISAAC. That depends on to whom you are speaking. If you ask the FDIC, I suspect it would tell you it has the authority to do exams whenever it jolly well feels like it. If you ask the Federal Reserve or the Comptroller of the Currency, they might have a different view.

But we have worked out with the Comptroller's Office a cooperative exam program under which we go into any troubled bank on a cooperative basis with the Comptroller's Office—half of the examiners are theirs and half of them are ours—we also pick out a number of larger banks to go into, whether or not they are troubled.

Senator PROXMIRE. What do you mean by cooperative? Supposing the regulator refuses, whether it's the Federal Reserve or whether it's the Comptroller? Supposing they say, no, we don't want you in this?

Mr. ISAAC. Well, the Federal Reserve has refused to enter into a cooperative exam program, so we are examining the institutions without their consent. The Comptroller's Office has not refused.

Senator PROXMIRE. Why couldn't Congress say that the FDIC should be allowed to examine any insured bank without being required to get the permission of the other banking agency? After all, what kind of private insurance company would stand for that kind of restriction on its ability to examine?

Mr. ISAAC. It doesn't make any sense at all to put restrictions on the FDIC's ability to examine an institution that it insures, but recognizing the political world we're in and the sensitivities involved, the FDIC has supported the proposal of the Bush task force, which is that the FDIC be permitted to examine any 3-, 4-, or 5-rated institution and to sample the 1- and 2-rated institutions. We can live with that.

Senator PROXMIRE. Well, the political world, that's what you're talking to. That's our responsibility. It seems to me we ought to give you that authority.

Mr. ISAAC. That's right. If you can enact legislation giving the FDIC unfettered authority to examine any institution it insures, I believe that that would be the appropriate thing to do, but I can live with less.

Senator PROXMIRE. Now the chairman was questioning you on capital ratio and I agree with you wholeheartedly, but you're going to be followed by a witness that does not, and I would like to get your answer to what he says.

One of our later witnesses, a man I've referred to already and a man who has a fine reputation, David Cates, has called your proposed higher capital standards, "a silly waste of market capital."

How do you respond to that?

Mr. ISAAC. Well, I don't think the FDIC ever has or ever will do anything that is silly. There may be a better way, but I don't think we've ever wound up doing anything silly. So I think he perhaps overstates his objections a bit.

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The 9-percent capital proposal, part of which could be met through subordinated debt, would not cost a well-run bank anything. It could attract the 3-percent subordinated debt at a price and put that money out in assets and earn a yield sufficient to offset the cost of the money. It would not cost a well-run bank anything. A bank that was more poorly run, took higher risks, would have to pay a premium for the funding; therefore, it would cost it something. If a bank took enough risk, it couldn't get the funding; therefore, it couldn't grow and create bigger problems for the FDIC.

MARKETPLACE WILL DISCIPLINE BAD BANKS

This proposal we have made is a way of involving the marketplace in the process of determining bank risk, whether on the balance sheet or off the balance sheet, whether reflected in a current value accounting system or not reflected. The suppliers of subordinated debt who are going to be sophisticated and adverse to excessive risk, are going to help us discipline banks. They are going to price capital. They are going to determine whether banks receive capital or not and how much it will cost.

Senator PROXMIRE. Well, that answer pretty much satisfies me, but let me throw you one more curve. This one comes from Joe Selby, Acting Comptroller of the Currency. On the same subject, he says this:

> We are concerned that proposals that further increase the capital-to-asset ratio, which is the FDIC's proposal, to require 9 percent capital ratio, are likely to be ineffective in strengthening our banking system and may even weaken it. For that reason, we believe that a risk-based capital requirement will afford the greatest protection to the deposit insurance fund.

How do you answer Mr. Selby?

Mr. ISAAC. Well, a risk-based capital requirement is no different than a 9-percent capital requirement, except that it's less effective. The regulators under a risk-based system would be saying, 6 percent is our minimum capital requirement for a well-run bank. If you take more risk, we, the regulators, are going to decide how much more capital you need and we are going to impose that requirement on you according to the following formula.

One problem with that is that any formula we come up with is going to create perverse incentives. People are going to see the formula and they are going to find ways to get around it.

Senator PROXMIRE. You're saying that 9 percent is much more objective and much fairer because it just applies across the board and you don't have to use your own individual regulatory judgment?

Mr. ISAAC. That is correct. It allows the marketplace to get involved in determining whether this bank should be able to get capital at all and what price it should pay for it. The subordinated debt will not cost a well-run bank anything. But if it's a poorly run bank it is going to be charged in order to get the subordinated debt. The marketplace is going to look at the bank and ask what it has in the way of foreign loans, what it has in the way of off-balance sheet exposure, what it has in the way of insider loans, what's its interest rate risk?

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The marketplace is going to look at all those factors and a lot of others and its going to say, "You're going to pay more for this subordinated debt or you're not going to get it at all." The marketplace would discipline institutions.

I think it's going to be a far more effective system than any regulator or group of regulators could possibly devise.

Senator PROXMIRE. Thank you.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

Bill, is it fair to assume that if we move to a risk-based premium system we would nonetheless still probably have a two-tier insurance system, if you understand what I mean by that term, that is to say, the Continental Illinois of the world will not be allowed to go into liquidation and the small banks will?

Mr. ISAAC. A risk-based premium system will not solve that problem.

Senator HEINZ. I assumed that. That's a separable, continuing kind of problem.

One of the interesting issues to contemplate with respect to risk-based premiums is when a depository institution goes into other lines of business, as you and others have advocated—underwriting anything from mortgage-backed securities, to real estate development, to insurance—it seems to me that since the capital of the bank and therefore the bank—the capital of the bank underwrites the financial wherewithal of the bank holding company, and the bank holding company therefore is spreading itself in other areas, that one could make an argument that somehow a risk-based premium system ought to take into account what a bank or bank holding company was doing in other areas.

If some bank decided through a subsidiary to get into a most speculative kind of real estate investment, building office buildings today in Houston, should we ignore that as something that we ought to put a premium on?

REGULATIONS ON FAR-FLUNG ACTIVITIES

Mr. ISAAC. We have endeavored to deal with the issue of State banks that are engaging in nontraditional banking activities. In the case of the securities activities, we have already promulgated a regulation. In the case of real estate development and insurance underwriting activities, we are in the process of promulgating a regulation.

We have said that if you're going to engage in certain of these activities we won't prohibit you from doing that, but you must get them into a separately capitalized and funded subsidiary and build a barrier between the bank and the subsidiary—different officers, directors, and the like.

Senator HEINZ. Just so we understand what you mean by separately capitalized, you mean using capital raised through the equivalent of the bank holding company?

Mr. ISAAC. Let's say that you have a $1 billion bank and to meet regulatory standards it needs $60 million in capital.

Senator HEINZ. Right.

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Mr. ISAAC. And it wants to have a securities affiliate that needs 5 million dollars' worth of capital. What we are saying is that you must create a separate subsidiary for the securities activity and we will not count the 5 million dollars' worth of capital that is dedicated to that subsidiary as part of the bank's capital in computing its compliance with our regulatory standards. Therefore, the bank must go out in the market and raise not $60 million but $65 million, $5 million of which is downstreamed into the subsidiary.

Senator HEINZ. To put the issue in sharper relief, let's assume you've got your $1 billion bank that has to have their $60 million or 6 percent capital, and they decide to take on Lloyds of London, underwriting tankers in the Persian Gulf, and they decide that they want a $1 billion insurance company and they need to raise $300 million in capital and what they do for this insurance business—and they're going to write a lot of insurance—what they do is the bank holding company goes out and they sell shares, they sell debt, they sell preferred, they sell junk bonds, and they raise themselves their $300 million and they go into the insurance business. And all their tankers get hit by the Iraqis or the Iranians and it's kind of a washup on the shore there.

They have hypothecated 300 million dollars' worth of wherewithal of the bank. They are a weaker institution. Their bank holding company owes all kinds of people all kinds of money.

Hasn't the ability of the bank holding company to put up additional capital for the bank been hurt?

Mr. ISAAC. It is hard for me to imagine this example because you've taken a very small bank with only $60 million in capital and you had its holding company raising $300 million, but let's assume that somehow they did that.

Senator HEINZ. Well, I'm just talking about the dynamics. Obviously, nobody is going to do what I just described, but just so we understand the dynamics.

Mr. ISAAC. All right. Let's assume they did that. When the holding company got in trouble, it would go bankrupt. The bank, its major asset presumably, if there were no intercompany dealings——

Senator HEINZ. But aren't there almost always subsidiaries to holding company dealings?

Mr. ISAAC. There are very tight controls on it and we can make them tighter. But assuming that the bank was not directly tapped to provide the capital and funding—which our regulations would prohibit it from doing—you would have a perfectly solvent bank and you would have a perfectly insolvent holding company. So the answer is that the holding company would go into bankruptcy.

Senator HEINZ. You have a solvent bank that at one point probably gave some money to the holding company. Cash went to the holding company. The bank has notes.

Mr. ISAAC. There are laws against that and our regulation would place even tighter restrictions on it. But assuming you have a perfectly solvent bank and you have an insolvent holding company, you send the holding company into a bankruptcy proceeding and you sell the bank to somebody else. I don't find that a particularly difficult situation to deal with.

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Senator HEINZ. And there's no extra risk to the FDIC in that scenario?

Mr. ISAAC. Is there no extra risk? I'm sure there's extra risk.

Senator HEINZ. But is there significant—but wouldn't there not be significant extra risk? You're putting a bank on the market. That affects its capital.

Mr. ISAAC. Any time we let institutions get into a broader range of activities, we are taking on some extra risk. Our job is to try to make a judgment about——

Senator HEINZ. Just so I understand the dynamics, to carry it through one more step, you put the bank on the market and people say, well, the management of that institution was really dumb, and we're just not going to pay all that much for it and where is the money going to come from for their capital requirements?

Mr. ISAAC. If you have a bank with $60 million in capital, and under your example we do, it shouldn't cost the FDIC a penny. The bank should be something that somebody would buy without any FDIC financial involvement.

Senator HEINZ. Well, I don't quite understand where its going from—if they have to raise more capital I don't quite understand where it comes from. It doesn't materialize out of thin air. It's got to come from the market. They've got to go to market and sell preferred stock or common stock to raise capital, don't they?

Mr. ISAAC. Well, somebody has to find the money to buy the bank and they——

Senator HEINZ. Well, that step 1 is transfer of ownership. Step 2 is increasing the capitalization. They're not the same.

Mr. ISAAC. The bank didn't need increased capitalization under the example you gave because it had $60 million in capital, none of which was depleted.

Senator HEINZ. I'd like to believe that. My time has expired.

The CHAIRMAN. Senator Cranston.

Senator CRANSTON. In your testimony you state that the FDIC is increasing its monitoring and analysis system, improving training facilities, and beefing up your enforcement system.

What specific actions are you taking and what improvements are you making in each of those areas?

IMPROVEMENTS ON MONITORING AND ANALYSIS SYSTEM

Mr. ISAAC. In the monitoring and analysis? I think that our examiners are being targeted much better on the 3-, 4-, and 5-rated institutions, relying on the primary regulators, be it the State authorities or whomever, to carry out the primary examinations on 1- and 2-rated institutions. We just sample the 1- and 2-rated institutions.

Our monitoring system has been vastly improved in the past few years. We have hired analysts for all of our regional offices, given them higher grades so that we have more skilled people to do the off-site analysis. We are buying all kinds of computer programs and equipment for our people to help them in these efforts.

I am much, much more confident in our ability to identify problems at an earlier stage and deal with them more swiftly today

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than I would have been 3 or 4 years ago. I think the system is vastly improved.

It's not just the FDIC. For example, the Comptroller's Office is doing an outstanding job in this area.

Senator CRANSTON. What additional steps do you feel need to be taken in order to enable you to spot potential problems more quickly and to better target really scarce personnel resources?

Mr. ISAAC. Well, one thing we need is more personnel, and we are hiring. We have been hiring for the past year or so and are greatly increasing our efforts.

Senator CRANSTON. Do you have authority to get who you need?

Mr. ISAAC. We have the ability to hire people. If you're asking me if its an easy process, "no". We wish we weren't subject to all the civil service rules and the Government pay scales and everything so that we could attract more people and compensate them more highly and have people stay with us longer.

Senator CRANSTON. Do you feel that you are able to spot potential problems adequately in advance and then seek remedial steps?

Mr. ISAAC. Yes; Senator Cranston, earlier I gave some numbers. Let me just repeat them quickly for you because you are having another witness coming up pretty soon who will give you some numbers that are wrong and I want to make sure you hear the right numbers.

There's been some question about whether our CAMEL rating system of banks is accurate in advance and then seek remedial steps? is accurate in predicting troubles, and the answer is that it is highly accurate. There are some figures floating around on 4- and 5-rated banks and how many failed banks were rated 4 or 5 back in 1981 through 1983.

No. 1, those figures don't include 3-rated banks and they should because 3-rated banks are considered troubled banks that need close supervision.

Second, our system has improved in the past several years.

By June 1985, 44 banks had failed. All of them were rated 3, 4, and 5 before they failed. If you go back to the previous exam, 98 percent of them were rated 3, 4, or 5. If you go back to the exam before that, 82 percent of them were rated 3, 4, or 5. The numbers are comparable for 1984. I won't bore you with any more statistics. Suffice it to say, the CAMEL rating system is highly accurate.

Now we could make it more accurate in predicting troubles. We could make all those numbers across the board 100 percent, but the problem is, to do that, we would probably include about 5,000 institutions that weren't problems and that wouldn't help us do our job. We've got to narrow down the list of banks we're looking at. I'd rather keep a couple of problem banks out of the system than to put 4,000 nonproblem banks in it.

Senator CRANSTON. That sounds sensible. Thank you very much.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. In your testimony you state:

> Deregulation necessarily requires that we strengthen our supervision of banks and that we reform our system of deposit insurance.

You and I have had some differences of opinion on the general subject of bank deregulation in terms of Glass-Steagall and the Bank Holding Company Act, but setting aside those disagreements

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on those aspects of legislation, don't you think that we should reform our system of deposit insurance and strengthen our supervision of banks before we move down the road further on deregulation?

DEREGULATION ASPECTS ANTICIPATED

Mr. ISAAC. If I thought that the system were extremely flawed and dangerous, I would agree, but I think we can proceed with deregulation and at the same time make the necessary reforms in supervision and deposit insurance.

Senator RIEGLE. Did you say——

Mr. ISAAC. In fact, we have been improving substantially the supervisory system over the past several years in anticipation of deregulation.

Senator RIEGLE. Now was your phrase, "if you thought it was extremely flawed and dangerous"—was that the phrase?

Mr. ISAAC. I'm sorry?

Senator RIEGLE. Did I understand the phrase you used to be "if it were extremely flawed and dangerous," if that was the phrase you used a minute ago?

Mr. ISAAC. Yes.

Senator RIEGLE. If you would not describe it as extremely flawed and dangerous, which I would hope it hasn't gotten to that point, how would you describe it? I take it it would be something short of that, but something that sets off some sense of alarm in you.

Mr. ISAAC. I am concerned about the regulatory structure and the way the insurance system operates. I think we must make reforms.

Senator RIEGLE. How concerned I guess is what I'm trying to understand—I mean, what's the sense of urgency and immediacy that we ought to attach to your recommendations and the need to move on this?

Mr. ISAAC. I have long felt that the reforms in the supervisory system and deposit insurance system are the most important subjects before us. They are more important than nonbank banks by a mile. They are more important than geographic restraints. They are more important than added powers. I am not trying to minimize those others because, as you know, I think they are very important.

Senator RIEGLE. I appreciate that and that's helpful to have it in a relative sense to these other subjects, but how important is it in an absolute sense? I'm really asking a question about the degree to which there are dangers here or the likelihood of worsening conditions should we not move in this direction? How important is this issue in and of itself to move on with haste and with some real speed?

Mr. ISAAC. It is very important in an absolute sense. We should move forward on it without delay.

Senator RIEGLE. So time really is important to us, in your judgment here?

Mr. ISAAC. Yes; and particularly since a number of the reforms we're talking about—such as the increased capital requirement and

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the like—are going to have to be phased in over an extended period of time. So we've got to get started.

Senator RIEGLE. Last week Bank of America reported a staggering $338 million loss which is the second largest loss in American banking history. The First Chicago for the second quarter also reported disappointing earnings. Their net income was down 81 percent to a figure just in the black, although they had a tax credit that enabled that to happen; otherwise, there would have been a loss.

I'm wondering what actions, if any, have the Federal regulators taken regarding these two institutions and how closely are you monitoring these institutions at this point?

Mr. ISAAC. Well, the primary regulatory authority with respect to the two institutions you mentioned is the Comptroller of the Currency and since the Comptroller will be here shortly I'll let him describe what actions they have taken.

I believe it's fair to say that the institutions are very carefully monitored by all three Federal banking agencies.

Senator RIEGLE. Well, I guess I'm referring to the part then that is your part of the monitoring. What is your sense for the seriousness of this problem in these institutions?

Mr. ISAAC. I don't believe either institution has a set of problems it can't cope with, but I believe that both institutions and their board of directors are going to have to be very diligent and make some changes.

Senator RIEGLE. Are there any other major banks that have problems similar to these that have not yet come to light? I'm not asking for names. I'm asking whether or not this is a condition that is a broader one in terms of big banks than just the two that are in the news.

Mr. ISAAC. There are other banks at any point in time that have their problems. Some of them made announcements before these institutions made their announcements and I suspect somewhere down the line we are going to have more of them make announcements. I'm not predicting anything. I'm just saying that's the way things are. Periodically, these firms run into some troubles.

Senator RIEGLE. Are we likely to see any of the large banks in the country, the very large banks in the country, coming into the news with problems like this in the next 90 days?

Mr. ISAAC. I hope not.

Senator RIEGLE. I hope not, too, but is it your expectation that that hope will be met, that we will not see any more of these, or are we likely to be reading about others?

Mr. ISAAC. Well, we'll just have to wait and see I guess. I really would not want to get into the forecasting business.

Senator RIEGLE. I think if you had a strong sense of confidence you probably wouldn't be reluctant to state it.

Mr. ISAAC. Even if I have a high level of confidence in it, if there's a 1-percent chance that somebody might cross me up and come up with an announcement after I said there isn't going to be any such announcement, then I've completely destroyed my credibility and I'm not going to do that.

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Senator RIEGLE. Well, that would be hard to do here because you've always been a very careful, forthcoming witness, at least to my judgment.

HUGE DEBT IN EVERY DIRECTION

But let me ask two other questions, if I may, Mr. Chairman. One concerns the overall pileup of debt in every direction that I look. I'm talking about overextending ourselves in terms of the use of credit and let me just give you the list as I see it and then I'd like you to give me your best sense as to what this means in the aggregate.

We obviously have the huge Federal debts, the $200 billion deficits that we all feel are too high and need to come down. We haven't had much success in bringing them. We've doubled the national debt roughly over a 5-year period.

Within the last month, we have become a debtor nation in terms of our international financial accounts, the first time since 1914, and the trend lines we're on say that within 1 year's time we will be the No. 1 debtor nation in the world. We're going to go right past Brazil and Mexico. No one is writing about that yet but it's a fact.

Our consumer debt-to-income ratio is as high as it's ever been. It's 72 percent and rising on an annual basis. We've got a lot of outstanding foreign loans that don't look very strong at the moment, and oil prices dropping which complicates that problem in certainly those countries where the debts are the highest.

We've got other kinds of internal problems. We've got the farm debt problem which is one that is a particular sectoral problem. We've got a lot of leverage buyouts taking place where we're substituting equity for debt in more corporate structures.

There are stories now starting to run about an increasing softness in the real estate market and a lot of outstanding mortgages underlying the recent boom in real estate development in a number of the areas where a lot of that has been happening.

And I add all of this up and I say to myself, it looks to me as if we've really stretched ourselves out in terms of the use of credit and the use of debt instruments in every direction beyond what seems to me to be a prudent aggregate. In other words, it seems we're stretching out against the outer limits of the credit system in ways that I don't know any contemporary parallel for. Some of these things that I've mentioned are brand new. We've not experienced them in contemporary history.

My question is this: As a person who's in the center of this puzzle, what should we draw from this kind of an overall credit and debt posture that we're in here where all these trend lines seem to be running the wrong way? Are we not to a point or are we not passing the point of prudent outer limits, if we haven't already? What observations can you make about it in the aggregate?

Mr. ISAAC. Certainly with respect to the Federal debt and budget deficits, we have certainly passed the point of prudence. In these other areas, I think there's a fundamental flaw in the system in that we allow people to deduct interest that they pay on their borrowings and we tax the interest they receive on their savings. I

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don't see how you could expect anybody to do anything different than what they are doing with those kinds of incentives and disincentives in the tax system.

We tax people who want to save and give people deductions who want to borrow and spend.

Senator RIEGLE. I think that's a reasonable point, but those have been the tax law provisions for quite a long period of time and it seems to me what has happened is that we're rocketing into a new circumstance in terms of our aggregate use of credit and debt. In other words, on all these different horizons that I've mentioned here, we have now it seems to me moved into a new zone of our overall debt load that's beyond anything anybody has ever seen before off the same tax laws that have been in effect for decades.

So is that the only thing that's driving it? What I'm really asking you is: Are we at a point where we really have to reverse these trend lines in a very significant way? Can we continue to just pile up additional debts in all these directions and lever ourselves higher and higher, or are we to the point where we may be in danger of inducing a collapse if we continue down this road?

Mr. ISAAC. I don't think these trend lines can continue indefinitely. We have to deal with them.

Senator RIEGLE. How serious are they, in your view, now?

Mr. ISAAC. I think they are very serious, particularly the Federal debt.

Senator RIEGLE. Can you disconnect that from all these other things? I mean, don't you have to really relate these things?

Mr. ISAAC. I think they are related, but I think that it's going to be awfully difficult for the Federal Government to take action on the other fronts when it's setting the kind of example it's setting.

Senator RIEGLE. Well, I agree that that's a top priority, but it seems to me we're going to have to move on all of them at once.

ADVOCATE CHANGES IN FED DISCOUNT WINDOW

My final question is this: In your appendix you advocate some changes in the Fed discount window and I wonder if you could just elaborate briefly on that?

Mr. ISAAC. The committee asked for our views on the lender of last resort function and how it might be changed, so in our statement we pointed out that it's a misnomer, as the Federal Reserve System presently operates, to call the Federal Reserve the lender of last resort.

The Federal Reserve does not take any risk or place itself in an exposed position with respect to loans it makes through its discount window. They are all more than fully collateralized. The only agency that is at risk in the banking system, the true lender of last resort, is the FDIC. We are the ones that wind up spending the money and taking the losses.

I have suggested two possible areas for reform. One is to authorize or direct the Federal Reserve to make unsecured loans available through the discount window to solvent institutions. If there are policy reasons for not wishing to pursue that, then I believe that the Federal Reserve should be directed before it makes a secured loan to a bank or thrift to obtain from the primary supervi-

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sor and the insurer a certification stating that the institution is solvent and that the extension of credit would be in the public interest.

Some people say, well, why should the Federal Reserve be required to make unsecured loans? Let's say you have a bank that is having a run on it and the Federal Reserve steps in and makes a secured loan. What you've done is you've let some uninsured depositors run—replaced by fully secured Fed borrowings. If the institution is insolvent, that's unfair to the unsecured, uninsured creditors who did not run, and it's also patently unfair to the FDIC its losses are increased. So the FDIC really ought to have some control over that process if secured loans are going to be made and we're going to get stuck with the losses.

Second, I don't believe secured loans by the Fed are calming. I believe it can be very disruptive to have the Fed making fully secured loans. Let's take Continental Illinois. In that case, the Federal Reserve put up $9 or $10 billion. But it had collateral equal to $20 billion or so. If I'm an unsecured, uninsured lender to Continental, I've got to be very concerned about continuing to loan the bank money when the Federal Reserve has $20 billion of collateral tied up. The Federal Reserve comes in and takes a lien against every good asset in the bank. What are the other lenders supposed to do? They're going to run.

If the Fed would come in with an unsecured loan, then there would be no reason for other unsecured lenders to run. They will say, "well, the Federal Reserve is stepping up, I should stay in." But the way it operated at Continental, the Federal Reserve came in and took every good piece of collateral they had. I don't think that's reassuring. I don't think that's stabilizing.

Senator RIEGLE. That's a very interesting point I think. Thank you for those observations.

Thank you, Mr. Chairman, for your patience.

The CHAIRMAN. Mr. Chairman, we thank you for your testimony. We have only scratched the surface, but due to the fact that we still have eight more witnesses we will have some additional detailed questions we will submit to you for your response in writing. I'm not going to eulogize you again today because you may be back again before you leave.

Mr. ISAAC. Well, I hope I will be, but you can go ahead and eulogize me.

The CHAIRMAN. I told you, we'll just have it reprinted in the record. Thank you very much.

Mr. ISAAC. Thank you, Mr. Chairman.

[The complete prepared statement and response to written questions follow:]

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Statement on Deposit Insurance and Supervisory Reform by William M. Isaac, Chairman, Federal Deposit Insurance Corporation

Mr. Chairman, members of the Committee, it is a privilege for me to lead off this series of hearings on deposit insurance reform and related supervisory issues.

It is not hyperbole to characterize the changes now taking place in the financial system as revolutionary. A structure put into place a half century ago, at the nadir of the Great Depression, is crumbling. In part this is occurring by design, but in larger part it is caused by the forces of economics and technology. The central question facing government today is not whether change will or should continue but, rather, how to insure that the financial structure that eventually results will best serve the public interest.

Deposit insurance has been an integral part of the financial system for over a half century, responsible in considerable part for the depository institution structure that has evolved and the nature of supervision and regulation of depository institutions. It is, therefore, impossible to consider any government action to fundamentally alter the financial structure without addressing the role of the insuring agencies.

Mr. Chairman, you have assembled many distinguished witnesses to testify at these hearings. They will offer a variety of opinions on how best to reform the system. At one end of the spectrum, some will likely advocate that we dismantle much of the governmental infrastructure and place virtually total reliance on market forces. At the other end, some will likely espouse a greatly expanded role for the government, particularly at the federal level.

We believe that each of these represents an extreme point of view. Proponents of the first approach would turn the clock back to 1925 and pretend the financial collapse of 1929 did not occur. Proponents of the second approach would turn the clock back to the 1960s and pretend the past quarter of a century did not occur.

We must endeavor to strike a balance. The collapse of 1929 did occur, and it taught us a lesson we must never forget: the government has a vital role to play in maintaining financial stability. At the same time, we must also recognize that in many respects we overreacted to the trauma of the Great Depression. We were not sure exactly what to fix so we fixed everything in sight, including some things that did not need fixing. We were far too zealous in our efforts to stifle competition and innovation.

Surely, if we have learned nothing else during the past couple of decades, we have learned that the marketplace will not indefinitely tolerate unnecessary and inefficient restraints. Either the restraints themselves or the businesses subject to them will be eliminated.

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Deposit interest rate controls are one example. The marketplace forced their elimination. If we had taken much longer to receive and act on the market's message, the damage to our nation's banks and thrifts would have been beyond repair.

There are other artificial barriers to competition that should be reduced substantially or abolished. They are weakening the regulated firms and denying the public the fruits of a fully competitive and responsive financial system. Specifically, I have in mind the restraints on interstate banking, the Glass-Steagall Act and the Bank Holding Company Act.

Since this hearing is not directed primarily at those issues, I will not dwell on them except to state that there are far better and less invidious ways to control potential abuses and concentration of economic resources. I am convinced that each of these three barriers to competition will eventually meet with the same fate as interest rate controls.

The FDIC remains totally committed to deregulation of financial services. It is good for banking, it is good for consumers and it is good for the nation.

But it is essential to recognize that deregulation -- i.e., the dismantling of artificial restraints on competition -- necessarily requires that we strengthen our supervision of banks and that we reform our system of deposit insurance. To fail to do either is a prescription for disaster.

A deregulated environment is more complex, faster paced. It requires more skilled, better trained examiners and analysts. It requires more reliable and sophisticated offsite monitoring systems to enable us to spot potential problems more quickly and better target our scarce personnel resources. Once abuses or unsound practices are uncovered, enforcement actions must be swift and strong.

The FDIC is moving aggressively in each of these areas. We are increasing staff, spending nearly $10 million per year to train our personnel and are deploying them where they are most needed. Major efforts are under way to improve our offsite monitoring and analysis systems. Our enforcement activities have increased fivefold in the past four years and the actions, including fines and removal of officers and directors, are considerably stronger. When banks fail, we are relentless in our pursuit of civil and criminal sanctions against the perpetrators.

While these efforts are critically important, we cannot and should not place total reliance on them. Promulgating countless new regulations to govern every aspect of bank behavior, and hiring thousands of additional examiners to enforce

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them, would be prohibitively expersive, would undercut the benefits sought through deregulation, would favor the unregulated at the expense of the regulated and would ultimately fail.

We must seek new ways, in the absence of rigid government controls on competition, to limit excessive risk-taking and abusive practices. We must enlist the support of the marketplace to instill a greater degree of discipline in the system. To accomplish this, we must reform the deposit insurance system.

The collapse of the banking system in the 1930s provided the impetus for the FDIC, even though the measure was opposed by President Roosevelt and the American Bankers Association. They believed the system would be too costly and would subsidize marginal, high-risk institutions at the expense of the well-managed firms. A compromise was agreed upon to provide modest coverage of $2,500 per depositor. Larger, more sophisticated depositors remained at risk and were expected to supply the necessary discipline.

Most of the early bank failures were handled by the FDIC as payoffs of insured deposits only. Depositors over the insurance limit were exposed to loss.

Eventually, the FDIC developed and employed more frequently the purchase and assumption transaction, whereby a failed bank was merged into another bank with FDIC financial assistance. The procedure offered some advantages. It was less disruptive because it automatically continued banking services for the failed bank's customers, and it tended to be less expensive to the FDIC because it preserved some of the franchise value of the failed bank.

An unfortunate side effect was that all depositors and other general creditors were made whole, thereby undermining discipline, but this flaw was of little concern in those relatively tranquil days. Only a handful of very small banks failed each year. Interest rate controls prevented banks from bidding for funds, so customers continued to have the incentive to do business with the banks that were perceived to be strong and could offer the best and most convenient services.

The deposit insurance system was largely transformed, through the purchase and assumption technique, into a system of de facto 100 percent coverage. The perception of 100 percent coverage became particularly pronounced with respect to larger banks when the FDIC infused capital into Bank of the Commonwealth in 1972; arranged mergers for United States National Bank in San Diego, Franklin National Bank and a few other sizeable banks during the mid-to-late 1970s; and infused capital into First Pennsylvania in 1980 and Continental Illinois in 1984.

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While de facto 100 percent coverage, or the perception of it, might not have been cause for much concern in the 1960s, it is enormously troubling in the decontrolled rate environment of the 1980s. How, in a deregulated environment where most depositors do not believe they are at risk, do we insure that funds flow to the vast majority of banks that are prudently operated instead of to the high flyers that pay the highest rates? The answer is clear: we need to restore an element of discipline in the system.

So one major objective of deposit insurance reform in a deregulated environment should be to achieve greater market discipline. This can be accomplished in any one or more of three ways: pull back from de facto 100 percent depositor coverage, find new ways to impose discipline through the capital accounts and implement risk-related premiums. These policy options are discussed in more depth in the appendix to our statement.

A second major objective of deposit insurance reform should be to achieve greater fairness in the system. The fairness issue takes two forms. First, there is the question of how bank failures can be handled so as not to discriminate or give the appearance of discriminating against smaller banks. Second, there is the question of how to allocate the cost of the deposit insurance system in an equitable fashion. For example, is it fair that the best bank in the country pays the same price for deposit insurance as the worst bank? Is it fair to exempt from assessments nearly two-thirds of the deposits of Citibank, while exempting only one-third of the deposits of the Bank of America and none of the deposits of the vast majority of the banks? Is it fair to require well-run banks to pay for the extra cost of supervising problem banks? These issues and a number of others, together with our recommendations for dealing with them, are also discussed in the appendix.

Next, there is the question of disclosure. If we place people -- whether depositors, suppliers of capital or both -- at risk in banks, they are entitled to full disclosure regarding the financial condition and practices of the banks. It is as simple as that. There are only two kinds of information about a bank that we believe should not be disclosed. We believe in strict confidentiality of customer information. We would also protect from public disclosure the ratings by bank regulatory agencies. The ratings represent our opinion, not fact. They are sometimes wrong, on either the low or high side, yet they would be accorded overwhelming weight by the public.

Whatever policies are adopted for banks in terms of capital, disclosure and depositor discipline, the rules must be applied equally to savings and loan associations. Partly for this reason, but mostly because of the need to strengthen the

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federal insurance system, we favor a merger of the FDIC and FSLIC. Our views on this are spelled out in more detail in the appendix.

Mr. Chairman, members of the committee, I thank you for this opportunity to testify on these matters of vital importance to our nation. We at the FDIC have long felt that the issues of deregulation, improved supervision and deposit insurance reform are inextricably intertwined. We cannot deal with one without addressing the others. This hearing is the first, that I can recall, that has attempted to pull them together.

If you are successful in this effort -- if you are able to enact a balanced, comprehensive measure that proceeds with deregulation, strengthens the supervisory process and reforms the deposit insurance system -- there is no question in my mind that the financial system will be made infinitely stronger. It will be a more stable and equitable system in which well-run institutions of all sizes will prosper and be fully responsive to the needs of the American public.

I and the FDIC will be more than pleased to assist you in this effort in any way possible.

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APPENDIX

A number of reforms have been suggested by the FDIC and others. The following represents the FDIC's views on many of them.

Discipline

There are two principal ways to achieve greater discipline in the banking system: through depositors and/or through the suppliers of capital. A third, complementary approach would be to implement risk-based deposit insurance premiums.

Depositors

Some suggest that the FDIC revert to the insured deposit payoff method for handling bank failures in order to instill greater discipline. The problem is, it simply will not work in large banks.

Take Continental Illinois for example. At the time of its near collapse, it had only $3 billion or so in insured deposits. With over $16 billion in its insurance fund at that time, the FDIC could have paid those depositors their money. But other creditors holding nearly $37 billion in claims, including some 2,300 small banks with $6 billion in claims, would have had their funds tied up for years in a bankruptcy proceeding. With nearly a million deposit accounts to process, even insured customers would have had to wait a month or two before receiving their funds. Finally, the FDIC would have been forced to liquidate a $30 billion loan portfolio.

Because of these types of problems, last year the FDIC developed and tested the modified payoff technique. It retains many of the advantages of a merger of a failed bank, while imposing a degree of discipline on large depositors. Insured accounts are sold through a competitive bid process to another bank, preserving some franchise value and minimizing the disruption to smaller depositors. Many loans and other assets are transferred to the acquiring institution, reducing the burden on the FDIC's liquidation staff. Instead of forcing uninsured depositors to await the liquidation of assets before receiving any funds, the FDIC conservatively estimates the present value of the receivership's ultimate collections and makes these funds -- say 60 or 70 cents on the dollar -- available immediately. Additional payments are made if and when collections warrant.

Though the modified payoff technique does not require legislation, some have suggested legislative alternatives along the same lines. To remove the uncertainty regarding the distribution to uninsured depositors, for example, Congress could provide that a fixed minimum percentage be paid -- say 80 or 90 percent of amounts over the $100,000 limit. A number of variations on this theme are possible.

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While the modified payoff technique and similar approaches to depositor discipline have considerable appeal, there are major drawbacks. First, it is difficult to envision policymakers actually being willing to utilize the technique in a very large bank. Market participants will probably never be convinced it will be employed unless and until it actually is.

Second, to the extent the technique is effective in bringing about discipline, it could be very disruptive. If we had never travelled down the path toward de facto 100 percent coverage in larger banks (not to mention thrifts) -- if all general creditors at Bank of the Commonwealth, Franklin National, U.S. National, First Pennsylvania and Continental Illinois had not been made whole -- the financial system would almost certainly be stronger today and less dependent on the implicit safety net. But we have traversed far along that path, and it will be extremely difficult to reverse course any time soon.

Third, the technique might not provide much discipline for the vast majority of banks. Some 12,000 banks are $100 million in size or smaller. Their deposits are nearly 95 percent fully insured or secured.

Fourth, the benefits of the exercise would largely be negated unless funds placed by money brokers and other institutional investors were denied insurance coverage. Otherwise, they will simply package and distribute the funds so as to obtain full insurance coverage.

Suppliers of Capital

On balance, the FDIC believes the disadvantages of depositor discipline, at this stage, probably outweigh the advantages. We would prefer to look to the suppliers of capital as our principal source of market discipline.

We have informally proposed that the minimum capital requirement for banks be increased from 6 percent to 9 percent over time -- say one-half percent per year for six years. The minimum primary capital requirement would be set at 6 percent with banks being permitted, but not required, to have the additional 3 percent in the form of subordinated debt.

A well-run bank would be able to raise the subordinated debt at little or no net cost -- i.e., the funds would cost the bank about the same as they would yield when invested in loans or other assets. A bank that took greater than normal risks would have to pay a premium for the subordinated debt. A bank that took excessive risks would not be able to obtain the subordinated debt at any price and would thus be precluded from

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growing. In this fashion, the marketplace would impose a very real discipline on bank behavior. Subordinated creditors, who unlike stockholders do not share in the rewards of successful risk-taking, will be very discerning in providing and pricing capital.

This proposal does not require legislation. It could be accomplished through regulation. But competitive equity would dictate that all three federal banking agencies, plus the Federal Home Loan Bank Board, act in unison. That does not appear likely in the absence of Congressional direction.

If the proposal were implemented, the FDIC could discontinue its efforts to achieve greater depositor discipline. We would recommend leaving the de jure insurance limit at $100,000, but we would in fact provide 100 percent coverage by endeavoring to arrange mergers for failed banks of all sizes.

The 9 percent capital proposal would equalize the treatment of large and small banks and minimize the disruptions from failures, while restoring discipline. The failure rate would almost certainly be reduced significantly, and the FDIC's losses at failed banks would be minimized.

The principal disadvantage of the proposal is that many banks and thrifts would be forced to raise a considerable amount of capital and/or restrict their growth. The burden would fall primarily on thrifts and large banks. A recent FDIC study, using year-end 1984 data, indicates a capital shortfall of $49.1 billion among FDIC-insured institutions, with $5.7 billion of the shortfall in the primary capital component. Banks could meet the higher standards over time by restricting growth, retaining earnings, issuing new capital or a combination of the three.

Some smaller banks have commented that the requirement would be especially onerous for them because, unlike large banks, they do not have ready access to the capital markets. We do not find this argument persuasive. First, as a group the 12,000 banks under $100 million in size currently have average primary capital equal to 9.1 percent. While many are below 9 percent, their deficiency is comparatively modest. Second, to the extent the deficiency cannot be met through retained earnings, controlled growth and the issuance of stock, it can be met through the private placement of subordinated debt with traditional institutional investors such as correspondent banks, insurance companies and pension funds.

While the proposal has drawbacks, particularly for thrifts and larger banks, the FDIC believes that implementation of it is entirely feasible, given a reasonable phase-in period. The advantages appear to outweigh the disadvantages.

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Risk-Related Premiums

The FDIC's deposit insurance reform legislation proposes risk-related insurance premiums as a third method for increasing discipline in the system. Today, all banks -- the best and the worst -- pay the same price for deposit insurance. This not only subsidizes excessive risk-taking, it is patently unfair.

Currently, banks pay a premium of 1/12 of one percent of domestic deposits for deposit insurance. The FDIC then deducts its losses and operating expenses and rebates 60 percent of the balance to the banks. Except for the past four years, when the FDIC's insurance losses have been extraordinarily high, the net premium after the rebate has averaged about 1/27 of one percent.

The FDIC proposes to divide banks into two or three risk categories based on an objective formula that measures such factors as capital, non-performing loans and/or interest-rate exposure. All banks would continue to pay the same basic charge for insurance (i.e., 1/12 of one percent), but the FDIC would be permitted to vary the rebate among the various risk categories of banks. Assuming a resumption of normal rebates, this would mean that a high-risk bank would pay a net premium of 1/12 of one percent, while a well-run bank might pay on the order of 1/30 of one percent. The FDIC's net income would not be affected.

In addition, the FDIC proposal calls for problem banks to pay the FDIC a charge for the increased cost of supervision they require, not to exceed 1/12 of one percent. Thus, a problem bank's total payments to the FDIC could be 1/6 of one percent, or nearly five times the 1/30 of one percent paid by a normal-risk bank.

Unlike some proponents, the FDIC does not view a risk-based premium system to be a panacea -- just a substantial improvement over the status quo. It would be less arbitrary and considerably more fair than the current system. It would provide a significant, though not overwhelming, financial incentive for banks to avoid excessive risk-taking and to correct their problems promptly. Perhaps as important, it would send a strong signal to a problem bank's management and board of directors.

Some people have criticized the FDIC's proposal because the financial penalty it would impose is perceived to be too modest and because the proposal does not have a sound actuarial basis. The FDIC acknowledges both problems but does not believe they should preclude moving forward. There is no actuarially sound basis for computing deposit insurance premiums at this time, nor will there be in the foreseeable future. We are able, today, to allocate the cost of deposit insurance more fairly than is done under the fixed-rate system. The FDIC feels

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strongly the time has come to implement a modest proposal along the lines suggested. After a few years' experience, we may well come back to the Congress for authority to undertake a more ambitious program.

Assessment Base

Two major categories of risk exposure for banks -- foreign deposits and off-balance-sheet liabilities -- are not included in the deposit insurance assessment base today, raising questions of fairness and soundness.

Foreign Deposits

When the FDIC was established more than 50 years ago, foreign deposits were comparatively insignificant and were excluded from both insurance coverage and assessments. Two things have changed in the intervening years. First, foreign deposits have grown to nearly 50 percent of total deposits at the top 10 banks. Second, through its actions at Franklin National, First Pennsylvania and Continental Illinois, the FDIC has provided de facto 100 percent coverage of foreign deposits. In view of this, is it fair to exempt foreign deposits from the assessment base? For example, Citibank in 1984 paid FDIC assessments of $18.5 million on $30 billion of domestic deposits but none on $49 billion in foreign deposits, while Bank of America paid $40 million on domestic deposits of $59 billion and none on foreign deposits of $30 billion. At the same time, thousands of smaller banks throughout the nation paid FDIC assessments on their entire deposit base.

Last year Senator Proxmire introduced a bill to include foreign deposits in the assessment base and lower the basic premium on all deposits from 1/12 of one percent to 1/15 of one percent. The proposal would be revenue neutral to the FDIC but would shift approximately $120 million per year in premiums from smaller to larger banks. The FDIC believes that unless Congress develops an acceptable means for assuring that foreign depositors are not protected by the FDIC when a large bank founders, the bill introduced by Senator Proxmire would represent a significant improvement in the assessment system.

Off-Balance-Sheet Liabilities

Our nation's banks, primarily the large ones, have hundreds of billions of dollars in off-balance-sheet liabilities, which are not subject to FDIC assessments or capital requirements. Yet if these banks fail, the FDIC will likely be forced to accept the exposure represented by many of these potential or contingent claims. It seems rather obvious this situation is neither fair nor actuarially sound. The question is what to do about it.

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One answer is that the regulatory agencies should undertake closer scrutiny of off-balance-sheet risks and factor them into the agencies' capital requirements in some fashion. The FDIC and the Comptroller of the Currency began work on this project last year.

But another important step should also be taken. The FDIC's deposit insurance reform bill would establish a uniform set of creditor priorities for all FDIC-insured banks, supplanting a hodgepodge of laws throughout the country. An important aspect of this legislation is that it would subordinate off-balance-sheet claims, such as standby letters of credit. This would protect the FDIC against loss and also impose a degree of discipline by encouraging the holders of these claims to be more careful in the selection of their banks. Finally, it would facilitate the handling of failures through mergers by allowing the FDIC to ignore these claims in calculating its "cost test."

If the FDIC's proposal to subordinate off-balance-sheet claims is not enacted, we believe that at least some of these claims, such as standby letters of credit, must be included in the assessment base.

Merger of the FDIC/FSLIC

The FDIC believes that a merger of the FDIC and FSLIC would create a stronger insurance system with greater resources, a larger income stream and a more diversified risk base. It would also facilitate interindustry takeovers of foundering institutions and unify the procedures for handling insurance claims.

The FDIC feels strongly that banks and thrifts should be required to abide by equivalent standards with respect to capital, accounting and disclosure. The FDIC would oppose any legislation to merge the funds which did not include a mandate to phase in common standards in these areas over a period of years.

If the funds were merged, the Federal Home Loan Bank Board would remain the primary supervisor of S&Ls. The FDIC's role would be comparable to the role it plays in national banks -- cooperatively examining larger and troubled institutions and generally helping to provide oversight.

Many bankers are opposed to a merger of the funds because they fear their institutions will be assessed to cover the cost of handling S&L problems. S&L executives have expressed the same concern in the opposite direction. We believe these objections can be overcome by calculating bank and S&L insurance rebates on a separate basis for each industry for a period of years until common standards on capital, disclosure and accounting are fully phased in.

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Other Issues

Lender of Last Resort

The Committee has specifically requested our suggestions for changes in the Federal Reserve's lender of last resort function. We believe it is a misnomer, as the system is structured today, to label the Federal Reserve as the lender of last resort.

The Federal Reserve does not place funds at risk through its discount window. All such loans to banks or thrifts are more than adequately secured. Increasingly over the years, the FDIC has become the banking industry's lender of last resort in the sense that it is the only agency at risk.

Consideration should be given to authorizing, even directing, the Federal Reserve to make discount window loans available to solvent institutions on an unsecured basis. If there are overriding policy reasons for not implementing this change, then at a minimum we believe the Federal Reserve should be directed to obtain, before granting a secured loan, certifications from an institution's primary supervisor and its insurer that the institution appears to be solvent and that the extension of credit would be in the public interest.

Role of Private Insurance

Even before the recent debacles in Nebraska, Ohio and Maryland, the FDIC was opposed to private or even state-backed deposit insurance plans. The track record for state and private deposit insurance plans in this country, dating back to before the Civil War, is dismal. The plans simply do not have the size, diversity of risk, regulatory authority or the personnel to weather a serious storm.

We believe that any institution which holds itself out to the public as a bank and accepts deposits should be required to obtain FDIC insurance. If a state or private plan wishes to provide secondary coverage above the FDIC insurance limit, we would have no objection, though we believe participation in the secondary plan by individual institutions should be voluntary.

Risk-Based Capital Requirements

Some commenters have suggested that the regulators ought to implement risk-based capital standards to control excessive risk-taking. The FDIC is sympathetic to these efforts, but some words of caution are in order.

It should be recognized that the agencies already employ risk-based capital standards. The federal banking agencies have for the first time in history adopted a uniform minimum capital

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standard for banks of all sizes. The minimum standard is applicable only to well-run banks. Banks with above-normal loan problems, weak earnings, poor management, excessive interest-rate exposure, a high growth rate or sizeable off-balance-sheet exposure are required to meet a higher capital standard on a case-by-case basis.

What the commenters apparently mean when they refer to a risk-based capital standard is that the agencies should develop an objective formula to substitute for the case-by-case analysis described above. If a formula could be developed that most people would agree is reasonable and does not create perverse incentives, the FDIC would be supportive.

This subject has been debated for decades, however, without a consensus being reached. The FDIC and the Comptroller of the Currency launched a joint study in this area last fall, but an acceptable formula is not in sight.

Finally, we should note that the 9 percent capital proposal discussed earlier offers some real advantages over a formal risk-based capital formula. By allowing investors in subordinated debt to gauge and price bank risk, the 9 percent proposal would be far less rigid than any formula established by regulatory fiat, would be less likely to result in perverse incentives and would be less likely to embroil the agencies and the industry in interminable debates about the precise formula to be applied.

Adequacy of the FDIC Fund

During the FDIC's first 47 years it handled $9 billion worth of failures and suffered insurance losses of $500 million. During the past 4½ years, it has handled nearly $30 billion in failures, excluding Continental Illinois, and its insurance losses have averaged $1 billion per year. Even while absorbing these record losses, the fund has grown dramatically by over 50 percent from $11 billion at the beginning of 1981 to over $18 billion today. The fund has never been stronger, with an average maturity in its investment portfolio of 2-1/3 years and portfolio market appreciation of $400 million. Gross income from assessments and interest will top $3 billion in 1985 and net positive cash flow is expected to exceed $5 billion.

Some commenters have suggested that the insurance fund be authorized to draw upon general revenues. The FDIC believes this is unnecessary and unwise, and we are adamantly opposed to it. The federal deposit insurance system was designed to be a self-help safety net supported solely by industry assessments. Except for the original seed money, which was repaid with interest before 1950, the system has not utilized a penny of taxpayer funds, and the FDIC is committed to maintaining that tradition.

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Enforcement Authority

The FDIC's deposit insurance reform bill would streamline the procedures for instituting enforcement actions against banks and their officers and directors, while maintaining due process safeguards. It would also provide the FDIC the full range of enforcement powers over all insured institutions as unanimously recommended by the Vice President's Task Group on Regulation of Financial Services. We believe these measures are essential and urge their prompt enactment.

FDIC Control Over Activities of State Banks

Suggestions are increasingly being made that because state banks operate with federal deposit insurance, the federal government or the FDIC in particular should be granted the authority to determine the permissible scope of their activities. The FDIC is greatly troubled by this notion.

Our nation has been well served for over a century by the dual or state/federal chartering system. It has been enormously valuable in helping to foster an innovative financial system. The states, for example, invented the checking account, experimented with the NOW account, led the way on various consumer protection measures and are now at the forefront in dismantling geographic restraints and breaking down outmoded, anticompetitive product-line barriers. At other times in our history, particularly in the 1960s, the federal government has led the way.

We believe the federal government must be extremely careful not to undermine the dual chartering system, the validity of which Congress recognized as recently as 1978 when savings banks were given the federal charter option under the Financial Institutions Regulatory Act and again in 1982 when the option was expanded under the Garn-St Germain Act. There have been very few state initiatives about which the FDIC has any concerns. We believe we already have the authority to promulgate appropriate safeguards in the few areas that are of some concern.

Our approach has been to carefully avoid prohibiting any activities but to require that certain of them -- for example, securities underwriting -- be conducted in separately capitalized and funded subsidiaries or affiliates. We are comfortable that these and other safeguards we have developed provide adequate protection for our insurance fund.

If it should ever be determined that we require additional authority to proceed along these lines, we would not hesitate to request legislation. We are fully cognizant of the need to preserve the integrity of our insurance fund and of the unique role it plays in maintaining stability throughout the financial system.

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FDIC

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

William M. Isaac
Chairman

Responses to Questions from Senator Garn

1) Should a federal insurance agency be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed institution with any profit after administrative costs arising from the transaction returned to the original stockholders?

The question appears to be based on the premise that all depositors of the institution would be made whole. While we do not necessarily have any problem with that result (assuming other mechanisms -- such as the FDIC's 9 percent capital proposal -- for maintaining discipline are implemented), it should be recognized that this approach is at odds with proposals for greater depositor discipline, such as the modified payoff.

On balance, we do not believe it would be necessary or desirable for the FDIC to acquire ownership of an operating institution without shareholder approval. It could lead to significant abuses for the insurer to wield such power. The current system -- which requires action by the chartering authority, rather than the insurer, to close a bank -- is less likely to result in abuses. We would, however, favor granting the chartering authority power to close a bank or force a merger at an earlier stage, before a bank is so clearly insolvent and the FDIC's losses are of significant size.

There are considerable advantages in forcing institutions to take corrective actions while they are still solvent and still have economic value. Those institutions unable to take corrective action would be forced to seek a private sector merger (on unfavorable terms, if necessary) while their institution still had value. This would lessen the number of actual failures and lessen the financial involvement in failures by the deposit insurance agency.

In the case of institutions not able to take corrective action or find a merger partner, an early closing of the institution would tend to lessen the risk and loss to the deposit insurer. If there is any residual value after general creditors (including the FDIC) are repaid, this value would be returned to subordinated creditors and stockholders.

2) If the burden of mismanagement were placed squarely on the managers and stockholders and most failures were handled through a purchase and assumption at an earlier stage - immediately or through a conservatorship - regardless of size - wouldn't this dispose of the fairness question as it relates to large and small institutions? Why couldn't a Continental type solution be applied to failing [illegible] all banks? If an insurance agency is funded totally by [illegible]ions is there a federal subsidy?

If all bank failures were handled through purchase and assumption transactions, small and large institutions would be treated similarly and

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there would be no fairness issue. The downside of this approach is that, unless capital standards were raised considerably and/or another class of creditors (subordinated debtholders) were brought into the picture, there would be insufficient restraint on risk-taking by banks.

A Continental-type solution could, in theory, be applied to small failing banks. However, if done on a widespread basis, the FDIC would own and operate banks throughout the nation, which would hardly be a desirable situation. The Continental transaction was structured as it was because a normal purchase and assumption transaction could not be consummated at a reasonable cost to the FDIC. Use of this method of handling bank failures should be avoided whenever possible. Moreover, when used, as in Continental, the FDIC should divest its ownership position as soon as possible.

If an insurance agency is funded by assessments on depository institutions, it is those institutions that bear the cost of the agency's operations. There is no federal subsidy involved.

3) What can be done to prevent covenants in subordinated debt agreements from requiring the FDIC to prevent losses to all creditors as well as the holding company?

First, legislation could be developed that would address short-term or interim FDIC assistance. Emergency type legislation, similar to the type that permits interstate mergers and acquisitions of large financial institutions, would be a useful tool for the FDIC. Cf., 12 U.S.C. 1823(f). Emergency agency action could take the form of a "staying" of the default of an institution's subordinated debt for 30 to 60 days upon the note becoming due and payable. This could give the FDIC an opportunity to "prop up" an ailing institution for a short time, allowing another institution to acquire the ailing one and assume the various debt obligations.

Second, legislation could be developed that would require FDIC-insured financial institutions (or their holding companies) to insert "regulatory assistance" clauses in any forthcoming subordinated notes. Such clauses would allow the FDIC, in the event the institution requires assistance, to aid the institution, at either the bank or holding company level, through various means (stock purchase, note purchase, restructuring, reorganization, refinancing, asset purchase, etc.), without triggering a default of the notes.

4) Is there a place for self-regulation in the banking industry that draws on the talent within the industry? If so, how could concepts of self-regulation be included in the federal supervisory system?

There are areas where industry involvement can and does improve the overall regulatory and supervisory process in the banking system. Bank comments are generally solicited in connection with proposed supervisory and regulatory changes. Advice from industry experts is frequently sought by regulators in other situations. The industry also plays a major role in helping develop accounting and reporting standards.

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Insofar as institutions share credit lines, lend to each other and evaluate the financial condition of other institutions, the industry provides a source of information and potential discipline on institutions within the system.

While all these things are important, our system generally does not and cannot rely extensively on self-regulation. There are limits to the role of self-regulation in a competitive environment. There are also limits to the potential interaction between the industry and those regulating it.

5) What is your view of Mr. Keefe's suggestions that

a. The current loan limit is too high?

b. Many banks fail due to excessive concentration?

c. A bank be required to list its 30 largest borrowers by type of company?

d. The largest banks be required to supply regulators with monthly data?

a. Loan limits vary greatly within the industry so it is difficult to generalize. National banks all operate under the same regulation; however, each state has its own lending limit laws for the banks they charter. The FDIC opposed the increase in the national bank lending limit from 10 percent to 15 percent adopted by Congress in 1982, and some consideration might be given to phasing it down to its former level and subjecting state-chartered banks to the same limit.

b. Excessive credit concentrations -- either to a single borrower(s) or to industry groupings -- are a leading factor in bank failures. A well-diversified bank is much less likely to encounter difficulty than a bank with heavy concentrations.

c. The basic idea of a bank developing information and reporting on its concentrations has merit. The regulators already gather this information through the examination process. Implementing a standard report for the information, however, might be difficult and costly to the industry. To be useful the reporting should not relate to just a certain number of large borrowers. Rather, some measure in relation to capital should be established -- the FDIC uses 25 percent -- and if aggregate credit to all borrowers in any industry segment exceeds that level it might be reported.

d. There is considerable merit in requiring data from the industry more frequently. The FDIC believes that the quarterly Call Report should be greatly simplified (to include only the information required for effective off-site surveillance) and required on a monthly basis for all banks. Perhaps the more complete Call Report currently in use could be required only once or twice per year.

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6) Should CPA audits be required of all depository institutions and their holding companies? What steps, if any, should be taken that would permit federal bank examiners to place more reliance on auditors' evaluation of management systems and controls? Would this help examiners focus on asset quality, and bank risk levels, etc.?

The FDIC has been shifting its emphasis away from examining small, well-managed banks every 12-to-18 months as it had in the past and is concentrating on the larger, more complex banks and troubled banks. As a result, the FDIC has been encouraging depository institutions (and, indirectly, their holding companies) to have audits performed by independent accounting firms. The FDIC has, however, resisted imposition of a universal requirement that all banks be audited. To be effective, an audit requires accountants who are knowledgable about and experienced in banking. The number of these CPAs is finite and not, in our view, large enough to immediately take on the task of regularly auditing all 14,500 banks.

Even with the present situation we have found serious audit deficiencies in several failed banks. This has occurred even though the audits were performed by nationally recognized firms. The quality of bank audits appears frequently to be insufficient.

The fees for audits can be high and constitute a major expense, especially for smaller banks whose in-house accounting expertise is nominal. Most importantly, the fee for audit services is paid by the client under audit and, consequently, the CPA's independence is frequently suspect because the auditor's natural desire to please and retain the client may lead to the condoning of the client's use of accounting practices that border on the unacceptable.

Unless some way can be found to satisfactorily resolve the fundamental questions of who pays the accountant's fee and to whom the accountant is responsible, we are not optimistic that a greatly expanded role for CPA firms will be feasible. We hope the accounting industry itself will come forward with some constructive proposals, because more reliable work by CPA firms could be of immense value to the regulatory agencies.

7) Would you recommend that federal depository agency personnel be exempted from government pay ceilings? If so, how can this be effectuated?

The FDIC as an independent, self-funded agency already has some flexibility in its compensation authority but as a matter of practice it has tried not to stray too far from general government policies. We would welcome an indication from the Congress that we should use our existing flexibility to a greater degree.

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8) What is your view of permitting federal regulators to require institutions to pay special assessments for the increased examinations made necessary by their classification as a problem institution?

The FDIC believes banks of supervisory concern -- those rated 3, 4 or 5 -- should pay for the cost of the additional FDIC supervision their condition requires. We have recently released a discussion paper on risk-related insurance premiums which incorporates a proposal to charge for additional supervision. This charge would be the lesser of the FDIC's actual cost or 1/12 of 1 percent. A copy of the discussion paper is enclosed. Most chartering authorities -- i.e., the Comptroller of the Currency and many state banking departments -- already charge banks for examinations.

9) How can the bidding process be improved and the cost of managing a failure reduced?

There are three potential changes which would improve bidding procedures and lessen the cost of managing failures. The interstate takeover provision in the Garn-St Germain Act should include a failing bank test instead of being limited to a failed bank standard. This would enable the FDIC to invoke the process at an earlier stage before the franchise value of the bank is completely eroded or a crisis atmosphere develops -- e.g., as occurred at Continental Illinois. Second, the Garn-St Germain threshold of $500 million in assets for interstate acquisitions should be amended to include the top 10 banks in the state even if below $500 million in size. Finally, consideration might be given to overriding restrictive in-state branching laws in a failed bank situation. For example, the complete absence of branching in Kansas and some other states has resulted in no bidders for a number of small failed banks and very modest premiums in other cases.

10) Should federal regulators be given any exemption from the burdens of the Paperwork Reduction Act? If so, when should they be exempt?

The FDIC, as an independent agency, has the ability to override OMB under the Paperwork Reduction Act. It is essential for the agency to retain that flexibility. Though the override authority has seldom, if ever, been used by the FDIC, the fact that it exists provides an important safeguard. It is our impression that OMB has used the Paperwork Reduction Act as a device to bring other agencies under its direct control. Congress might consider re-examining this issue to determine whether OMB is going beyond what is necessary and appropriate to achieve the laudable objective of reducing the number of forms and reports required by the federal government.

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11) If regulators are rarely surprised by a bank failure - isn't the answer swifter or more appropriate regulatory action rather than increased market discipline? Wouldn't giving the regulators the ability to close an institution earlier be appropriate? Should a regulator require bank management to file a confidential bank failure plan approved by its board of directors if it falls a certain percentage below its minimum capital level for a specified period of time?

The regulators have a number of methods to deal with problem banks and they are normally successful. In a minority of cases, there comes a point where the problems become so pervasive that only a massive injection of new capital will prevent failure. There is no regulatory action that can force investors to buy capital in a distressed bank. As mentioned in response to Question 1, it would be desirable for the chartering authority to have the ability to close banks earlier as that would likely lower the cost to the FDIC as receiver. The FDIC has also requested certain changes in Section 8(a) of the FDI Act which would allow more speedy proceedings for termination of deposit insurance. These proceedings seldom result in actual cancellation of insurance but they do force a resolution of the situation. The FDIC has also requested the ability to take the full range of enforcement actions against any insured bank, as unanimously recommended by the Bush Task Group. These measures, while extremely important, should be regarded as a complement to, not a substitute for, market discipline.

It is not clear what is intended with regard to the contents or objectives of a "Bank Failure Plan," which might be filed by an institution's board of directors if capital falls below a certain level for a specified period of time. Weakened institutions, through supervisory oversight and formal enforcement actions (including the new capital directive program), are encouraged and required to formulate plans and to recapitalize their institutions to a level appropriate to preclude a closing. It must be recognized that sometimes these plans will not work. No regulatory system will prevent all bank failures without becoming so rigid as to be unacceptable.

12) What percent of total bank earnings are paid in deposit insurance premiums each year? Has this percentage gone up or down over time? Is there much variance bank to bank or by size of institution?

Table 1 shows net FDIC premium income as a percent of commercial bank and mutual savings bank before tax net operating income for the past five years. This percentage has generally increased over this time period, the result of significantly increased premiums and relatively stable bank operating income.

Premium expense as a percent of before tax net operating income can vary significantly from bank to bank. This is a result of substantial variations in income among banks and reflects differing deposit bases. As indicated in Table 2, the premium-percentage variation among different size classes of banks with less than $10 billion in assets is relatively small. As a group, banks with assets over $10 billion, however, pay a

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lower relative percentage. This difference is attributable mainly to the non-assessable deposits (i.e., foreign deposits) maintained at these larger banks. Generally speaking, a bank's premium expense falls somewhere between 2 to 8 percent of before tax net operating income.

TABLE 1: NET FDIC PREMIUM INCOME AS A PERCENT OF COMMERCIAL BANK AND MUTUAL SAVINGS BANK NET OPERATING INCOME (BEFORE TAX), 1980 - 1984

Year	Net FDIC Premium ($ Millions)	Bank Net Operating Income ($ Millions)	Percentages
1980	$ 431	$19,219	2.24%
1981	922	18,485	4.99%
1982	1,013	17,594	5.76%
1983	1,051	18,792	5.59%
1984	1,254	20,486	6.12%

TABLE 2: 1984 PREMIUM EXPENSE AS A PERCENT OF COMMERCIAL BANK AND MUTUAL SAVINGS BANK NET OPERATING INCOME (BEFORE TAX), FOR VARIOUS SIZE GROUPS

Asset Size ($ Millions)	Premium Expense as a Percent of Net Operating Income
Less than 100	6.8%
Between 100 and 500	6.1%
Between 500 and 1,000	6.8%
Between 1,000 and 10,000	6.4%
Greater than 10,000	5.2%

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13) There appears to be strong support for required risk-based capital - as a method of calculation of capital or as a supplement to the flat rate capital ratios. Would this necessarily lead to higher capital standards? Is there any need for legislation in this area if such risk-based standards were to be applied equally to all institutions?

Since the American Bankers Association has formally opposed risk-based capital requirements, we are not sure there is "strong support" for the notion. Some commenters have suggested that the regulators ought to implement risk-based capital standards to control excessive risk-taking. Depending on what is meant by those who advocate risk-based capital standards, the FDIC is very leery.

It should be recognized that the agencies already employ risk-based capital standards in the sense that poorly performing banks are required to maintain more capital than well-run banks. The federal banking agencies have for the first time in history adopted a uniform minimum capital standard for banks of all sizes. The minimum standard is applicable only to well-run banks. Banks with above-normal loan problems, weak earnings, poor management, excessive interest-rate exposure, a high growth rate or sizeable off-balance-sheet exposure are required to meet a higher capital standard on a case-by-case basis.

What the commenters apparently mean when they refer to a risk-based capital standard is that the agencies should develop an objective formula to substitute for the case-by-case analysis described above. Some have suggested that certain types of activities would be subjected to higher or lower capital requirements based upon the perceived degree of risk inherent in the activity.

This type of system, in our judgment, would be very difficult to implement and has the potential to be highly mischievous. First, there is no objective way to accurately measure levels of risk among different asset categories. Whether a given type of activity is risk (e.g., mortgage lending) is dependent in large part on the quality and experience of the management conducting the activity. Second, perception of risk is of necessity colored by past experience; we unfortunately do not have the ability to see around the next economic corner. Some of the most troubled loans on the books of banks today were perceived by most people to be some of the best loans five or six years ago. Third, we are very concerned that a system of assigning different levels of capital to various types of loans or activities could someday be misused as a device to allocate credit toward or away from certain sectors. Fourth, as contrasted with the 9 percent capital proposal, a risk-based capital system fails to address the central issue of how to handle the failures of large and small banks in an even-handed fashion. Fifth, no formal system of risk-based capital can be designed which will operate as accurately or as fairly as the current informal system under which our examiners use the on-site examination process to evaluate risk levels in banks and make demands for additional capital (above the minimum requirement) on a case-by-case basis. Sixth, we believe that under the 9 percent capital proposal, the suppliers of subordinated debt will be far

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more discerning about pricing levels of risk (whether on or off the balance sheet) than any arbitrary formula we could devise. Finally, it will be extremely difficult to obtain interagency agreement on a complicated risk-based capital formula. It has taken the three federal banking agencies nearly fifty years to arrive at a uniform policy on capital, and we would be distressed to see the agreement fall apart within a year of its adoption.

There is one variant of a risk-based capital system that avoids most of the problems mentioned above and, therefore, has considerable appeal. This system, called the "simplified risk asset ratio," would largely exclude U.S. Treasury securities from capital requirements but would include some or all standby letters of credit (in all cases, the current 6 percent minimum requirement would be retained). While this proposal requires some further study, it appears entirely feasible and may represent a significant improvement over the current capital formula. It would not necessarily lead to higher levels of capital in the industry and would not require legislation.

14) In 1981 and 1982, the banks and thrifts were suffering from disintermediation - their better customers were flocking to money market funds in droves. Now the concern seems to be that the higher quality loan customers are able to fill their needs elsewhere. The banks point to commercial paper, and the securitization of their loan portfolio. They claim that this trend is being caused in part by their capital ratios and reserve requirements. What is your view? What recommendations do you have for us in this area?

There is feeling among some banks that the existing capital requirements have prevented banks from pricing their loans as competitively as they might otherwise prefer. However, there is no empirical evidence in support of this contention.

The FDIC believes adequate capital is essential for the maintenance of a privately owned banking system. The safety and soundness of the banking system should not be sacrificed by lowering capital requirements merely to allow banks to compete more aggressively with nonbank lenders (which, generally speaking, have higher capital ratios than banks). Rather, a more reasonable approach would be to allow banks broadened powers to engage -- either directly or indirectly through subsidiaries or affiliates -- in the full range of financial services, including at the very least securities, insurance and real estate activities.

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15) With regard to the concern that some states may have expanded banks product authorities beyond what may be prudent, can this issue be dealt with by giving the federal insurance agencies the authority to require a prudent level of capital to support that activity in order to maintain insurance - rather than giving any federal agency the authority to override a state legislature? In other words, wouldn't the adoption of risk-based capital standards go a long way toward solving this problem?

As mentioned in response to Question 13, the FDIC is very leery of risk-based capital standards, particularly if utilized in the manner suggested by this question (i.e., to encourage or discourage certain types of business endeavors). The FDIC does not believe it is necessary or desirable for the federal government to undermine the dual or state/federal banking system by dictating the permissible scope of activities of state-chartered banks or thrifts.

Suggestions are increasingly being made that because state banks operate with federal deposit insurance, the federal government or the FDIC in particular should be granted the authority to determine the permissible scope of their activities. The FDIC is greatly troubled by this notion.

Our nation has been well served for over a century by the dual chartering system. It has been enormously valuable in helping to foster an innovative financial system. The states, for example, invented the checking account, experimented with the NOW account, led the way on various consumer protection measures and are now at the forefront in dismantling geographic restraints and breaking down outmoded, anticompetitive product-line barriers. At other times in our history, particularly in the 1960s, the federal government has led the way.

We believe the federal government must be extremely careful not to undermine the dual chartering system, the validity of which Congress recognized as recently as 1978 when savings banks were given the federal charter option under the Financial Institutions Regulatory Act and again in 1982 when the option was expanded under the Garn-St Germain Act. There have been very few state initiatives about which the FDIC has any concerns. We believe we already have the authority to promulgate appropriate safeguards in the few areas that are of some concern.

Our approach has been to carefully avoid prohibiting any activities but to require that certain of them -- for example, securities underwriting -- be conducted in separately capitalized and funded subsidiaries or affiliates. We are comfortable that these and other safeguards we have developed provide adequate protection for our insurance fund.

If it should ever be determined that we require additional authority to proceed along these lines, we would not hesitate to request legislation. We are fully cognizant of the need to preserve the integrity of our insurance fund and of the unique role it plays in maintaining stability throughout the financial system.

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16) Mr. Isaac has stated that a significant number of bank failures are caused by fraud other than increased enforcement actions which are being taken by the federal agencies - aren't Mr. Homan (Former Senior Deputy Comptroller for Bank Supervision, Office of the Comptroller of the Currency) and Mr. Ryan (Former Director, Division of Banking Supervision and Regulation, Federal Reserve System) right as to the importance of the on-site exam to ascertain the integrity of the numbers being generated and the lack of fraud? If so, does the decrease in on-site examinations bring with it an increase in the risk of fraud? If so, how can this be corrected?

On-site examinations are essential for verifying the accuracy of Reports of Condition, Reports of Income and other data submitted to the regulators and for detecting fraud. The FDIC has never and will never de-emphasize the on-site exam (indeed, the FDIC began earlier this year to increase its examiner force by 40 percent over a 12-month period). The FDIC has de-emphasized routine exams of smaller, nontroubled banks in favor of more frequent exams of larger and troubled banks. Common sense dictates that the resources of the insurance agency be directed to those areas where its exposure is greatest. The FDIC has emphasized the development of better off-site monitoring systems. These systems do not replace the on-site exam but, instead, enable the FDIC to better deploy its examiners to where they are most needed.

17) Even though the FDIC continues to grow, how can or should we determine if the size of an insurance fund is sufficient and will continue to be sufficient?

During its first 47 years, the FDIC handled $9 billion worth of bank failures and suffered losses of only $500 million in the aggregate. During the past five years, the FDIC has handled over $75 billion worth of failures (including Continental Illinois) at a cost of approximately $5 billion. Despite these staggering figures, the FDIC's insurance fund has grown by over 70 percent from $11 billion at the beginning of 1981 to over $19 billion today. Not only has the fund grown dramatically in absolute dollars during this period, it has grown as a percentage of insured deposits, reversing a long-standing decline. The numbers pretty well speak for themselves. We could not recommend any changes to enhance FDIC revenues at this time.

18) In your opinion, what are the advantages and the disadvantages of risk-based capital and risk-based premiums? Should we consider one or the other or both? Why?

As noted in our response to Question 13, the FDIC is leery of current proposals for risk-based capital.

The FDIC's deposit insurance reform legislation proposes risk-based insurance premiums. Today, all banks -- the best and the worst -- pay the same price for deposit insurance. This not only subsidizes excessive risk-taking, it is patently unfair.

We recently published a proposed system for implementing risk-based deposit insurance (copy enclosed). We have already received a number of

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comments from bankers on the system, and they are overwhelmingly supportive.

Currently, banks pay a premium of 1/12 of 1 percent of domestic deposits for deposit insurance. The FDIC then deducts its losses and operating expenses and rebates 60 percent of the balance to the banks. Except for the past four years, when the FDIC's insurance losses have been extraordinarily high, the net premium after the rebate has averaged about 1/27 of 1 percent.

The FDIC proposes to divide banks into two risk categories (normal and above normal) utilizing both the examination process and the results of a statistical technique called probit analysis. The probit test would objectively measure key financial ratios relating to factors such as capital, loan performance and earnings. For a bank to be placed in the above normal risk category, it would have to fail the objective probit test and be rated 3, 4 or 5 under the CAMEL rating system which is derived from on-site examinations.

All banks would continue to pay the same basic charge for insurance (i.e., 1/12 of 1 percent), but the FDIC would be permitted to vary the rebate among the risk categories of banks. Assuming a resumption of normal rebates, this would mean that a bank in the above normal risk category would pay a net premium of 1/12 of 1 percent, while a normal risk bank would pay less than 1/27 of 1 percent because it would receive its pro rata share of the rebate forfeited by the above normal risk banks. The FDIC's net income would not be affected.

Moreover, as noted in response to Question 8, the charge for additional supervision for banks rated 3, 4 or 5 would be the lesser of the actual cost incurred by the FDIC or 1/12 of 1 percent. This would mean that these banks would pay a total of 1/6 of 1 percent, compared to less than 1/27 of 1 percent by normal risk banks.

Unlike some proponents, the FDIC does not view a risk-based premium system to be a panacea -- just a substantial improvement over the status quo. It would be less arbitrary and considerably more fair than the current system. It would provide a significant, though not overwhelming, financial incentive for banks to avoid excessive risk-taking and to correct their problems promptly. Perhaps as important, it would send a strong signal to a problem bank's management and board of directors.

Some people have criticized the FDIC's proposal because the financial penalty it would impose is perceived to be too modest and because the proposal does not have a sound actuarial basis. The FDIC acknowledges both problems but does not believe they should preclude moving forward. There is no actuarially sound basis for computing deposit insurance premiums at this time, nor will there be in the foreseeable future. We are able, today, to allocate the cost of deposit insurance more fairly than is done under the current fixed-rate system. The FDIC feels strongly the time has come to implement a modest proposal along the lines suggested. After a few years' experience, we may well come back to the Congress for authority to undertake a more ambitious program.

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19) If the FDIC were given the authority to make risk-based rebates of premiums, what specific criteria would it base such rebates on?

Basically this question is answered in our response to Question 18, but at the risk of some repetition, very briefly the process would be as follows.

Determination of risk is basically a two step process. Based on Call Reports, prepared and submitted by the bank, the FDIC would select those which appear to be above normal risk. This selection would use a statistical technique to create an index consisting of the following items as a percent of assets: nonperforming assets, net loan charge offs, primary capital and net income. A finding of above normal risk would then be confirmed by a current examination rating of 3, 4 or 5 or discarded if the current rating is 1 or 2. Only banks which both "fail" the statistical profile and have an adverse examination rating would forfeit their assessment credit.

20) In March, I introduced S. 760, the Federal Deposit Insurance Improvements Act of 1985, at your request. For the record, could you explain the mechanisms advocated by that bill as a solution to the problems you consider in your testimony?

S. 760, or the Federal Deposit Insurance Improvements Act of 1985, contains several provisions which are very important to the effective and efficient future operations of the FDIC. This is a brief outline of the major provisions of the bill.

Section 6 of the Improvements Act provides for "risk-based rebates" on insurance assessments. The FDIC would have to continue to rebate 60 percent of its net assessment income to banks, but it would be permitted to rebate the overall amount "in such proportions and according to such procedures as the Corporation may by regulation prescribe." Our response to Question 18 states the FDIC's views on this subject.

Section 9 of the Improvements Act authorizes the FDIC to charge fees for examinations and investigations of banks. The fees are required to be reasonably related to the costs the FDIC incurs in conducting such examinations and investigations and may not exceed 1/12 of 1 percent of deposits in any event.

Section 10 of the Improvements Act establishes, as a matter of pre-emptive federal law, the following uniform set of priorities for the payment of claims against the estate of a failed bank, replacing a hodgepodge of state laws:

Preference #1: Claims for administrative expenses of the receivership.

Preference #2: All claims for deposits and all other claims, whether liquidated or unliquidated, which have accrued and

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become unconditionally fixed on or before the date the bank or branch is closed, except as provided in Preferences 3 through 6.

Preference #3: All claims other than those which have accrued and become unconditionally fixed on or before the date the bank or branch is closed, except as provided in Preferences 4 through 6.

Preference #4: Claims for subordinated debt issued to the Corporation.

Preference #5: Claims for subordinated debt other than claims that qualify for Preference 4.

Preference #6: Claims by shareholders based on stock ownership.

These preference provisions are necessary because they would assure that depositors (including the FDIC, in its corporate capacity, as subrogee of insured depositors) and other holders of fixed, non-contingent liabilities of the bank would be reimbursed before other claimants from the proceeds of a failed bank's estate. Booked liabilities would be given priority over ones that are merely contingent (such as standby letters of credit). The priorities also make it much more practicable to calculate the "cost test" -- that is, the relative costs of paying off the creditors of a failed bank versus arranging a purchase and assumption transaction for the failed bank's estate. Once the priorities become federal law, the FDIC will not have to include the nonbook liabilities in the calculations, making it easier to do P&As instead of deposit payoffs.

Section 11 of the Improvements Act vests the FDIC with greater flexibility to provide assistance in open-bank mergers. It enables the FDIC to arrange mergers for all eligible open banks, not just for eligible open mutual savings banks. It also enables the FDIC to arrange a merger for an eligible open bank if it is the subject of an outstanding assistance program, even if the bank is no longer in danger of failing. These additional powers would greatly enhance the FDIC's ability to arrange merger assistance for troubled banks, without the economic trauma which usually accompanies a bank failure.

Section 19 of the Improvements Act provides the FDIC with permanent authority to arrange emergency interstate purchase and assumption transactions. This authority is necessary to enable the FDIC to continue to deal effectively with large bank failures.

Other major provisions of the Improvements Act would: eliminate nonfunded letters of credit from the definition of "deposit" (to eliminate the present ambiguity in the industry and in the courts on this issue); and expand FDIC enforcement powers (to better enable the FDIC to mandate compliance with the FDI Act in order to assure safe and sound banking practices).

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Responses to Questions from Senator Armstrong

1) Generally the FDIC is very expeditious in closing an institution. The institution is normally liquidated, merged or sold over-night.

In the case of an institution in receivership or in conservatorship who is responsible for the operation and performance of the institution during that period? Is the Board of Directors and management staff personally liable for losses or decisions that might have been incurred during this period?

2) Does not a question arise concerning the liability of the interim management the longer an institution is in receivership or conservatorship?

3) When conservatorship powers are invoked shouldn't Congress limit the personal liability of the bank officers and Board of Directors if the institution stays in that status for longer than 30 days?

In order to provide you with a more thorough answer to your question, some explanation is required as to the FDIC's function as receiver of a closed institution. As you will see below, the FDIC does not act in a conservatorship capacity.

Although it is often stated that the FDIC is the regulatory body that has declared a problem bank insolvent and has therefore "closed" the bank, this is not correct. The regulatory body responsible for declaring a problem bank insolvent and closing the institution the chartering authority for the institution. For a national bank, the Office of the Comptroller of the Currency is responsible for making the determination. For a state-chartered bank, it is the state banking authority that makes the finding of insolvency.

The FDIC acts as a receiver of a failed institution subsequent to the decision of the appropriate chartering authority to close the institution. It is important to note that a conservatorship is distinct from a receivership. Whether it be a national or state bank, the FDIC acts in a receivership capacity, not as a conservator. The bank is no longer a viable institution able to transact banking business. The charter is revoked and the receiver's purpose is essentially limited to concluding the outstanding affairs of the bank. By contrast, often the chartering authority will determine that the problem institution is not insolvent or should not otherwise be closed. In such cases, the chartering authority may elect to place a conservator in the bank as a last effort to correct some of the outstanding problems in the bank or to further investigate its condition. The institution is not closed and can still operate as a going concern.

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As you might infer from the above discussion, once a bank has been declared insolvent and the FDIC has been appointed as its receiver, the Board of Directors and management staff of that institution are no longer involved in the operations or management of the bank. The bank is no longer an ongoing business concern. Accordingly, in response to your inquiry, the closed bank's board of directors and management staff are not personally liable for any "post-closing" losses or decisions that might be incurred during the administration of the receivership. Of course, the bank's board of directors and management staff would be liable for any legally actionable preclosing losses or judgments.

In conclusion, for the FDIC and receivership purposes, it does not appear that Congress needs to limit the personal liability of the former bank officers and board of directors because they are not liable for post-insolvency decisions made by the FDIC acting as receiver. Their liability is limited to preclosing acts or omissions. On the other hand, Congress may find it desirable to enact specific provisions that would limit the personal liability of those acting on behalf of the FDIC in its receivership capacity. Such a need may become more acute as the assets acquired by the FDIC acting as receiver become more complex to administer and liquidate.

4) I am interested in learning more about the use of consultants by federal deposit insurance agencies. I have recently become aware of instances where consultants have approached third parties to provide certain services to property secured by a troubled institution, but actually having no legal authority to do so. Services have been performed but no payment has been forthcoming and the service providers find the consultant is not the responsible party.

The FDIC, of course, cannot be responsible for the actions of consultants who have approached third parties and requested services for properties held by troubled institutions. I can assure you, however, that if the FDIC contracts for services with a consultant, we stand ready to fulfill our contractural obligation if services are performed as agreed. As a matter of practice, the FDIC never retains consultants to work on the affairs of a bank; the FDIC's occasional contracts with consultants are for the exclusive benefit of the FDIC.

5) Under what circumstances would the FDIC be likely to hire outside consultants to manage failing institutions or their assets?

It is not the FDIC's policy to hire outside consultants to manage failing institutions.

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6) It is my understanding that the FDIC uses its own personnel in most instances to manage an institution in receivership or conservatorship. If a consultant were hired to advise or operate the institution what legal status does the consultant have to FDIC? Does it change if the institution moves from receivership to conservatorship status?

The FDIC does not hire consultants to operate failed institutions. The FDIC does not have statutory power to operate a conservatorship. The FDIC does utilize the services of brokers, appraisers, property managers, and other kinds of specialists to assist the FDIC in the liquidation of failed banks. Generally, these services are arranged in accordance with local practices, which are outlined in formal agreements or contracts. The servicer's legal status is as an independent contractor.

7) In the course of liquidating an institution, if the FDIC were to find that it is responsible for operating a business that was financed by the failed bank and the agency hires a consultant to operate or manage the asset - what legal responsibility is the consultant under? Can he bind or represent that he can bind the FDIC to commitments he has made?

Generally, the FDIC attempts to avoid directly operating a business; however, if a business is acquired through a failed bank, management may be hired to operate the business. The FDIC, in its receivership capacity, has all the rights a shareholder would normally have when management is guilty of misfeasance. The FDIC's liability for losses would be limited to the amount of the investment in the business.

8) When consultants are used why shouldn't we require a disclosure of the legal status of the consultant to the federal agency and the legal status of the property/business for which the consultant negotiates?

We are not aware of the nature of the problem to be addressed, so it is difficult to take a position on the proposal.

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Responses to Questions from Senator D'Amato

1) The failure of Golden Pacific National Bank in New York's Chinatown is the most recent in a rash of bank failures across the nation. Chinese-Americans who invested their savings in this bank were confident that their savings would reap a solid return and would remain safe while invested in the bank. The illegal operations of several members of this bank forced the closing of the bank.

Chairman Isaac, I ask you, what can be done to prevent banks from operating in such a manner? As I understand it, this bank was operating in an illegal manner for quite a while, why is a situation such as this allowed to continue for a prolonged period of time?

Breaches of fiduciary duty and responsibility by bank directors, officers or employees, often involve complex transactions which are well concealed and extremely difficult to detect. Occasionally, these activities can be concealed over an extended period of time from others in the institution itself and from auditors and examiners. Once detected, the improper activities are dealt with as rapidly as possible, as was the case with Golden Pacific National Bank in New York. For more specifics on that particular bank, you might wish to contact the Comptroller of the Currency.

Swift public prosecution of the perpetrators of bank frauds will act as a deterrent to others. Any individual case of fraud raises legitimate questions regarding bank controls, regulatory supervision and outside audits. Nevertheless, no system will promptly uncover all acts of fraud unless that system is so overwhelming as to stifle day-to-day business activities.

2) Due to recent bank failures across the nation, there has been a growing concern, which may be justified, that the insurance fund may not be large enough to protect the industry. Could you comment on this?

Please see the response to Senator Garn's Question 17 for a more complete answer, but essentially we believe the present level of insurance assessments is adequate to meet the risk faced by the FDIC, and see no reason why there should be any adjustment to this approach or recapitalization of the FDIC at this time. Implementation of risk-based insurance premiums, which we favor, would allocate net assessments among banks differently, although in the FDIC proposal it would not affect the overall level of assessment income.

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3) Do you believe the assessment process for determining deposit-insurance premiums may require reevalaution? Please explain.

As noted in response to Question 18 of Senator Garn's letter, the FDIC supports the concept of risk-related deposit insurance premiums and has recently developed a proposal which we have sent to all banks (a copy of this proposal is enclosed). We also feel that some changes in the assessment base may be necessary. Two major categories of risk exposure for banks -- foreign deposits and off-balance-sheet liabilities -- are not included in the deposit insurance assessment base today, raising questions of fairness and soundness.

When the FDIC was established more than 50 years ago, foreign deposits were comparatively insignificant and were excluded from both insurance coverage and assessments. Two things have changed in the intervening years. First, foreign deposits have grown to nearly 50 percent of total deposits at the top 10 banks. Second, through its actions at Franklin National, First Pennsylvania and Continental Illinois, the FDIC has provided de facto 100 percent coverage of foreign deposits. In view of this, is it fair to exempt foreign deposits from the assessment base? For example, Citibank in 1984 paid FDIC assessments of $18.5 million on $30 billion of domestic deposits but none on $49 billion in foreign deposits, while Bank of America paid $40 million on domestic deposits of $59 billion and none on foreign deposits of $30 billion. At the same time, thousands of smaller banks throughout the nation paid FDIC assessments on their entire deposit base.

Last year Senator Proxmire introduced a bill to include foreign deposits in the assessment base and lower the basic premium on all deposits from 1/12 of one percent to 1/15 of one percent. The proposal would be revenue neutral to the FDIC but would shift approximately $120 million per year in premiums from smaller to larger banks. The FDIC believes that unless Congress develops an acceptable means for assuring that foreign depositors are not protected by the FDIC when a large bank founders, the bill introduced by Senator Proxmire would represent a significant improvement in the assessment system.

Our nation's banks, primarily the large ones, have hundreds of billions of dollars in off-balance-sheet liabilities, which are not subject to FDIC assessments or capital requirements. Yet if these banks fail, the FDIC will likely be forced to accept the exposure represented by many of these potential or contingent claims. It seems rather obvious this situation is neither fair nor actuarially sound. The question is what to do about it.

One answer is that the regulatory agencies should undertake closer scrutiny of off-balance-sheet risks and perhaps factor them into the agencies' capital requirements in some fashion. All three federal agencies are working on this project.

But another important step should also be taken. The FDIC's deposit insurance reform bill would establish a uniform set of creditor priorities for all FDIC-insured banks, supplanting a hodgepodge of laws throughout the country. An important aspect of this legislation is that it would subordinate off balance sheet claims, such as standby letters of credit. This would protect the FDIC against loss and also impose a degree of discipline by encouraging the holders of these claims to be more careful in the selection of their banks. Finally, it would facilitate the handling of failures through mergers by allowing the FDIC to ignore these claims in calculating its "cost test."

If the FDIC's proposal to subordinate off-balance-sheet claims is not enacted, we believe that at least some of these claims, such as standby letters of credit, must be included in the assessment base.

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The CHAIRMAN. Our next witness is Joe Selby, Acting Comptroller of the Currency.

STATEMENT OF H. JOE SELBY, ACTING COMPTROLLER OF THE CURRENCY

Mr. SELBY. Mr. Chairman, in the interest of time and since my statement is in the record, I will just summarize my statement.

[The complete statement follows.]

Mr. Chairman and members of the Committee, I am quite pleased that you have called these hearings on the bank examination and supervisory process. In recent years, significant economic and technological developments have put pressure on banks' performance and on the ability of the regulators to supervise banks effectively. The environment has undergone rapid changes, and both banks and their regulators are hindered in their ability to respond to these changes. The Congress, the regulators, and the banks all have a part in ensuring that the industry has a healthy transition into the volatile, dynamic financial marketplace of today and the future. Today, I would like to discuss what the OCC is doing, and what Congressional action is needed, to help assure this transition. These are the views of the OCC and may not represent the position of the Administration.

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Before discussing changes needed in the supervisory area, I would like to provide the Committee with our views of the fundamental goals of government regulation of the banking industry and discuss why the attainment of those goals has become more difficult in recent years.

ROLE OF GOVERNMENT IN A CHANGING ENVIRONMENT

Without question, it is in the interest of the Federal government to ensure the ongoing safety and soundness of the banking system. Banks have unique and vital roles in the payment system and in the conduct of monetary policy. To achieve safety and soundness, the government seeks to maintain a statutory and regulatory framework that promotes the long-term health and viability of the industry. The government also seeks to control risk and ensure confidence in the banking system by monitoring the condition and performance of individual banks.

Our goal of maintaining the safety and soundness of the national banking system requires sufficient oversight of, and interaction with, bank management to minimize the likelihood of bank failure. We do not take over and manage institutions; we cannot substitute for private management in making lending or most other decisions. The primary responsibility for any bank's performance rests with its management and board of directors.

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However, as supervisors we do monitor risk exposure, work to see that banks have in place policies and controls appropriate to their level of risk, and enforce compliance with the law. When we identify weaknesses, we institute corrective measures and pursue their implementation. This results in significant improvement in the vast majority of institutions that we identify as having problems. For example, two-thirds of the banks that were subject to our special supervisory program in 1980 showed sufficient improvement to be removed from the program by year-end 1984.

Our bank regulatory system is not designed to prevent all bank failures. To do so would require either nationalization of the banking industry, or the elimination of all risk -- one consequence of which would be to preclude banks from funding the nation's economic growth. Banks that become so weakened as to become insolvent must be allowed to disappear from the system. In such cases, our role is to minimize the impact of bank failures on other banks, on the public, on the deposit insurance fund, and on the system as a whole.

The government's ability to maintain safety and soundness has become more difficult in this decade because of dramatic, ongoing changes in the environment in which banks operate. As we and others have recounted on many occasions, economic and

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technological factors have put pressure on bank performance. Interest rate volatility has increased interest rate risk. Economic volatility and disinflation have caused a deterioration of asset quality. The necessary adoption of new technologies has created short-term cost pressures. Concurrently, competitive pressures have been intense as other financial service providers, less encumbered by statutory restrictions, have entered the banking business.

In short, the business of banking is becoming riskier and more complex. Clearly, the supervisory process must adapt to these phenomena if it is to continue to be effective. This important issue will be my focus today, but it should be noted that supervisory changes alone will not suffice. Two other areas need to be addressed if the long-term safety and soundness of the industry is to be assured.

First, as we have testified on numerous occasions, the relaxation of product and geographic restrictions should proceed if banks are to keep pace with less regulated competitors in meeting market demands. Currently, banks have only limited ability to adjust to changes in their environment. While other financial service providers have diversified, expanded, and innovated to keep pace with new technologies and market demands, banks have largely had to sit on the sidelines. New product and

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geographic flexibility will enable banks to meet consumer demands and make a viable transition into today's marketplace.

Second, the deposit insurance system should be restructured so that banks cannot take on risks without bearing both the costs and rewards resulting from those risks. Reform should include instituting risk-related insurance premiums which would be disclosed to the public and exposing large uninsured depositors and creditors to losses when a bank fails. I do not believe that market discipline should be reserved only for subordinated debt holders (as contemplated in the FDIC's 9 percent capital proposal), while de facto deposit guarantees are provided for uninsured depositors.

In the remainder of my statement, I will discuss how we supervise banks, changes we are making in the supervisory process, and what actions need to be taken to address vulnerabilities in bank supervision.

THE SUPERVISORY PROCESS

The OCC is the primary regulator and supervisor of the 4,900 national banks, with responsibility for ensuring safety and soundness and compliance with the law. OCC supervision relies on monitoring the performance of banks (through periodic on-site

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examinations and off-site analysis of reported financial data), enforcement activities aimed at requiring banks with problems to take steps towards rehabilitation, and public disclosure of financial information to facilitate the exercise of market discipline.

On- and Off-Site Monitoring

Our examinations have four objectives: 1) to provide an evaluation of a bank's financial condition; 2) to permit the OCC to appraise the quality of bank management and directors; 3) to identify those areas where corrective action is required to strengthen the financial condition and management of the bank; and 4) to identify and pursue corrective action where compliance with applicable laws, rulings, and regulations is inadequate.

To achieve these objectives our examinations focus on an evaluation of the bank's management and its policies, procedures, and controls. It is not feasible, nor is it our role, to perform an extensive auditing or verification function in every bank. While we do limited verification, we emphasize a "top-down" approach aimed at determining the ability and commitment of management and the board of directors to comply with the law and maintain the soundness of the bank.

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Resource considerations and the complex nature of the banking system require that supervision be tailored to the characteristics and condition of the bank being examined. It is particularly important that we direct our efforts to areas that pose the greatest risk or otherwise cause the greatest concern. Therefore, the OCC conducts off-site monitoring of the condition of banks to complement our on-site examinations and help us determine supervisory priorities.

Our approach to industry risk analysis illustrates this interaction. Sectors vulnerable to economic fluctuations or that exhibit structural weaknesses adversely affect the asset quality of the banking industry. For this reason, the OCC collects information on bank concentrations of credit by industry sector. Banks with significant exposure to industries with difficulties receive increased supervisory attention including additional reporting requirements and priority scheduling of on-site examinations.

After each examination a bank is assigned a rating, on a scale of one to five, commonly known as the CAMEL rating. The CAMEL rating summarizes a bank's overall condition at the time of an examination. It is one of several supervisory tools that we and the other agencies use internally to identify those

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institutions that warrant a higher than normal degree of supervisory attention.

The CAMEL rating has often been misinterpreted by those outside the banking agencies as a predictor of a bank's financial condition. It is not. It is merely a rough summary of examination findings. We do not update the rating between examinations, even though off-site surveillance of a bank may indicate a change in its condition. If through such surveillance we determine an on-site examination is in order, examiners are sent into the bank. Only at the conclusion of such an examination would the CAMEL rating be changed.

While the CAMEL rating system is not intended to be an "early warning system", it is a reliable indicator of the health of the banking system. Increases in the number of banks with CAMEL ratings of three or higher generally precede an increase in the number of bank failures. In fact, of the national banks that failed between 1981 and 1984, 71 percent were rated three or worse 1 year before failure, and 91 percent were rated three or worse 6 months before failure.

Enforcement

OCC has been utilizing enforcement actions vigorously in recent years to correct violations of law and imprudent banking

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practices. While advances in on-site and off-site monitoring techniques have been key in identifying problems, the enhanced enforcement authority Congress gave us in 1978 has improved our effectiveness enormously.

The severity of our enforcement actions largely depends on the severity of the problem. Actions range from memoranda of understanding for minor infractions or problems to cease and desist orders. In appropriate cases, our measures also involve the imposition of civil money penalties and the removal of bank officials.

We believe that we have been very successful in meeting our principal goal in the enforcement area -- guiding problem banks in a way that forces actions that restore them to a safe and sound condition. Despite the dramatic growth in enforcement actions in recent years, they are not disproportionate to the number of banks requiring special attention. The number of problem banks increased from 257 in 1980 to 775 in 1984 and the number of formal enforcement actions increased from 169 in 1980 to 515 in 1984. While the public has become increasingly aware of bank failures, we believe that it is a credit to bank supervisors that a far greater number of troubled banks each year are put on the right track.

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Disclosure

Public disclosure of a bank's financial condition is the third element of supervision. Currently all national banks are required by law to publish quarterly balance sheet information in a local newspaper. Bank Call Reports and Uniform Bank Performance Reports, which summarize bank performance relative to comparable banks, are available to the public through the Federal Financial Institutions Examination Council. In addition, publicly held banks and registered bank holding companies face the extensive disclosure requirements of the securities laws.

Disclosure complements our supervisory efforts by allowing the marketplace to participate in the discipline of banks. Publicly held banks are very concerned about the view that the investment community has of their condition and prospects. A downgrading of a bank's or holding company's debt, for example, would have a deleterious effect on its ability to raise funds. This acts as a powerful incentive for the bank to strive for superior performance. Also, in those cases where banks have had to disclose our enforcement actions, we have found that the bank's concern over regaining the confidence of the marketplace is an important inducement to respond to the corrective action.

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SUPERVISORY CHANGES

The increased risk and complexity in the marketplace in which banks operate create new challenges for both banks and regulators. CCC has continued to meet these challenges, to the best of our ability, by adopting measures that shift the focus of our efforts towards ensuring that the banks themselves have the ability to manage risk. These measures address the adequacy of banks' management, their loan loss reserves, internal controls, and capital. They also include improving the means by which we obtain information about banks' activities and efforts to make management more accountable to the marketplace through increased disclosure.

Because a bank's loan loss reserve is an important line of defense against the effects of bad loans, we are paying increased attention to the adequacy of a bank's reserves, relative to the total risk in its portfolio. Where we find such reserves inadequate in comparison to a bank's domestic and/or international problem loans, we are requiring immediate additions to such reserves. That addition has an immediate effect upon bottom-line earnings and often warrants a restriction of dividend payments.

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A bank's internal control systems are critical to the sound management of the bank, particularly as the risk and complexity of its environment increase. Our supervision focuses on determining whether banks have adequate internal control systems that enable management to identify and control risk in the bank's operation. Examiners test these control procedures and their applications and conduct stringent follow-ups to determine if internal control deficiencies are corrected.

The increased level of risk in the banking system clearly requires a strong capital base. I commend the Congress for enacting the International Lending Supervision Act of 1983 which provided the regulators with explicit statutory authority to prescribe and enforce capital ratios. Earlier this year, under the authority of this Act, the three federal banking agencies imposed a uniform minimum capital-to-asset requirement for all commercial banks. These minimums apply to well-managed banks; higher ratios are being imposed on banks with material weaknesses, and can be backed by the use of legally enforceable capital directives.

We view our recent capital regulation as an interim step towards a capital policy appropriate to a riskier environment. Since 1984, the OCC has been working to develop capital standards that would more formally recognize differences in

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overall risk among banks. The rather simplistic capital-to-asset ratio approach has two serious deficiencies. First, it may lead to less liquidity at banks. All assets are treated equally in the calculation of the ratio, so banks, in an effort to maintain their return on equity, have an incentive to hold higher yielding, riskier assets. We have seen banks sell high quality assets such as Treasury securities that provide relatively low rates of return and invest the proceeds in riskier and less liquid commercial loans and other assets.

The second problem with a capital-to-asset requirement is that it fails to explicitly take into consideration other risks assumed by a bank. It therefore encourages banks to shift activities off of their balance sheets. Several foreign bank supervisors now include off-balance sheet activities in their capital ratios. We are concerned that proposals to further increase the capital-to-asset ratio, such as the FDIC's proposal to require 9 percent capital ratio, are likely to be ineffective in strengthening the banking system and may even weaken it. For that reason, we believe that a risk-based capital requirement will afford the greatest protection to the deposit insurance fund.

The OCC recognizes that developing a practical risk-based capital policy will be difficult and will raise industry

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concerns with respect to their ability to remain competitive with other financial service providers and foreign banks. Nonetheless, we believe that this approach is a correct one and encourage industry and Congressional input into this process.

Timely and accurate information concerning banks' activities is necessary to identify risks in the banking system and better target resources to problem areas. To this end, we made a concerted effort in the 1970s to automate much of the information collected and develop a centralized database of critical information from quarterly bank Call Reports. Development of this database has facilitated more in-depth analysis of a bank's performance over time and has enabled us to identify institutions in need of special attention. To improve the quality and timeliness of our information, we plan to participate in a pilot program for direct automated transmission of Call Report information in 1986. In addition, we support the Federal Reserve Board's recent proposal to improve bank holding company reporting as a first step towards getting meaningful holding company data.

To further enlist the marketplace in controlling risk within banks, the OCC is currently considering a proposal to require banks to increase disclosure. In particular, it would extend to all banks disclosure requirements similar to those faced by publicly held banks and registered bank holding companies. We

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recognize the potential burden this would place on smaller banks and will weigh that against the public benefits of such disclosure. The extensive requirements faced by the larger banks have imposed substantial market discipline on them, and we expect our proposal will do the same for smaller banks. It will also enable depositors and investors to better gauge the performance of all individual banks and thus make informed decisions on where to place funds. We feel that it is important that the banks themselves, not the regulators, make the disclosures. Not only would it be expensive for the regulators to make individual disclosures for each of the 15,000 commercial banks, but we believe inordinate weight would be given to the disclosure because of its source.

Together, these changes will enhance the effectiveness of bank supervision and strengthen the banking system. Bank management and directors will have increased accountability to their shareholders, their depositors, their supervisors, and the public.

Nonetheless, our supervisory process is still vulnerable. There are a number of areas where Congress can provide us needed flexibility to make the appropriate changes. I want again to stress that these views are the OCC's and not necessarily those of the Administration.

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A NUMBER OF VULNERABILITIES REMAIN

Our supervisory approach remains vulnerable in three areas. First, banks have become subject to increased risks due to more volatile economic conditions, technological change, and increased competition. Second, fraudulent activities can be extremely difficult to detect. Third, we do not always have available the most comprehensive, up-to-date information. Things can change quickly in the banking business, yet we face lags in receiving reported data. Moreover, banks are increasingly engaging in new activities, which outpace changes in our regularly collected data.

The Congress and the supervisory agencies must work together to find ways to address these areas of vulnerability. It is critical to the safety and soundness of the banking system that the supervisory process be able to adjust to this decade's dynamic environment.

Resources

The OCC has always had to allocate resources between activities aimed at ensuring the safety and soundness of the banking system and checking for compliance with the law. In the past two decades, however, the number of statutes requiring

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bank compliance have increased dramatically. Banks have had to create the new position of a compliance officer, and the regulators have devoted an increased share of their resources to enforcing these new statutes.

In the 1970s, a relatively strong and stable banking industry raised fewer safety and soundness concerns and enabled the OCC to emphasize compliance. More recently, however, a dramatic increase in the number of banks requiring special supervisory attention has forced the redirection of resources towards the evalution of the financial performance of banks. While we obviously have not been able to accomplish 100 percent of everything, we are satisfied with the way we have balanced our priorities.

Our ability to effectively supervise national banks is dependent on our having a cadre of experienced capable examiners. The OCC has devoted millions of dollars in recent years on training programs and new supervisory techniques (such as increased use of microcomputers) in an effort to meet its responsibilities. Fortunately, our examining staff is composed of bright, dedicated, and hardworking individuals who are willing to serve in the public interest with little recognition of their good work. But this self-sacrificing service cannot be expected to last forever.

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Our biggest, and most critical problem, therefore, is our inability to retain the quantity and quality of experienced personnel required to examine and supervise banks. Once hired, new entrants are provided with extensive training. It takes approximately 5 years of training and apprenticeship for a new hire to become a national bank examiner.

Unfortunately, the long-term compensation prospects for trained agency personnel do not compare favorably to that of the banking industry. As a consequence, a number of mid-level and senior examiners leave every year to join the banking industry. The agency's turnover rate of 14 percent is well over four times that of the Federal Government as a whole. While this is obviously a tribute to the quality of OCC examiners, it places a heavy burden on remaining examiners and severely limits our ability to undertake the examination effort we think is required. To remedy this problem, we need to be able to offer salaries competitive with those offered in the banking industry. Until this is done, the limits on compensation of government employees make it impossible for us to retain the number of qualified personnel required.

An additional burden for examiners and another impediment to effective bank supervision, is the absence of absolute immunity for examiners from civil damage suits that seek to

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impose personal liability. The threat of potential litigation has a chilling effect on the action of bank examiners. Effective bank supervision requires examiners to make difficult judgments. The personal savings of examiners should not be subject to potentially harassing litigation for making these judgments. We support legislation presently pending that would provide this protection to all federal employees.

We have also experienced a drain on resources due to increased litigation. First, there has been a substantial increase in private litigation involving national banks. Even though this Office is not a party to such litigation, we are being inundated with discovery requests from litigants seeking reports of examination, examiner workpapers, correspondence files, and examiner testimony for use in such litigation. This Office expends a disproportionate amount of resources objecting to, defending against, and responding to such requests. We would request that Congress grant us relief from this burden by statutorily placing this information beyond the reach of civil discovery in cases in which this Office is not a party.

The OCC has also incurred substantial costs in investigating and litigating abusive insider cases. To facilitate an aggressive enforcement program, consideration

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should be given to permitting us to impose penalties sufficient to cover the costs of investigation and litigation.

Information Needs

As noted earlier, the agency relies heavily on its ability to obtain accurate and timely information on a bank and its activities. Detecting fraud in financial institutions is difficult even under the best of circumstances. Moreover, a number of barriers to cooperation among law enforcement officials have been erected. The Right to Financial Privacy Act of 1978 (RFPA), grand jury secrecy rules, and other state and federal privacy laws all impose certain impediments. We support the overall objective of those statutes and rules, but have found that they unduly restrain government information gathering and the free flow of information among agencies.

For example, the RFPA has limited our ability to coordinate with other Federal agencies. In addition, the rigid rules under which grand jury information may be made available for use in the preparation of civil enforcement activities has, in some instances, prevented us from receiving information that may have been useful to remove officials or prevent a change ownership. In addition, under those rules, examiners who participate in a grand jury investigation are precluded from

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using the information they receive for regulatory purposes and may even be disqualified from participating in future civil regulatory activities involving the subject matter of the grand jury investigation. I urge Congress to examine these statutory barriers to interagency cooperation and to consider how those impediments might be reduced without seriously compromising the important interests they were intended to preserve. The Administration has introduced legislation, which we support, that addresses some of the difficulties imposed by the RFPA.

It is absolutely essential that we have the ability to obtain accurate and timely information to fulfill our supervisory responsibilities. During a time of economic fragility and rapid change, adequate and timely information is the keystone of our supervisory structure.

Another barrier to our ability to obtain adequate information is the lack of protection afforded bank "whistle blowers". OCC requires national banks to report suspected criminal acts. Individuals who come forward to do so may be subjected to possible retaliation by the bank or its officials -- particularly where they may be reporting the suspected criminal acts of their superiors in the bank. To provide such individuals with some form of legal protection, consideration

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should be given to creating a specific federal right to sue for wrongful discharge.

Flexibility Needs

A particularly troublesome constraint faced by the OCC is the lack of flexibility we have been given to deal with problem banks. When a bank is identified as having serious financial difficulties, and we have exhausted all the usual means to correct the situation, our ability to require major changes in an open bank's operations or management is limited. Typically, it is not until a bank's capital or liquidity is exhausted that a regulator can step in and merge a weak bank with a strong bank.

There are several approaches to dealing with this problem. First, incompetent management must be removed before irreversible damage is done to the bank. Of course, the primary responsibility for replacing management rests with a bank's board of directors. However, for those instances where a board of directors is unwilling or unable to exercise its responsibility to provide sound management, it is necessary for regulators to have adequate authority to deal with problem management.

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Under current law, the procedures for removing management are cumbersome and the standards are difficult to meet. Legislation has been proposed by the FDIC and FHLBB to address some of the problems. We believe it would be appropriate to revisit the existing laws in this area to increase the regulators' flexibility to deal with ineffective management.

Another approach to dealing with problem institutions, and reducing the cost to the public and the FDIC of a bank failure, would be to respond earlier and more forcefully to problem institutions. If a bank could be closed at exactly that point when the owners' capital had been exhausted, then in theory neither the FDIC nor other creditors or depositors would suffer a loss. Unfortunately, imprecise measurements of the market value of a bank's assets and our inability to close a bank prior to its reaching a point of book insolvency (except in the case of a liquidity insolvency) generally result in failed banks having capital deficiencies. In other words, by the time the regulators can close a bank under existing policy, the market value of the bank's assets are usually less than the outstanding claims against the bank by its depositors and general creditors. As a result, either the FDIC and/or the creditors and depositors suffer a loss.

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Such a loss could be minimized if the regulatory agencies were provided with expanded authority to deal with open banks determined not to be viable over the long-term. For example, a policy could be adopted that any time a bank's capital falls below 3 percent (the level at which the FDIC generally considers termination of deposit insurance), the primary supervisor would be given the authority to require the owners to seek a merger partner or to liquidate the bank. Alternatively, a conservator could be appointed by the primary supervisor with authority to exercise the full range of powers possessed by bank management, including the sale of the bank.

To implement such a policy, the OCC needs additional operating flexibility under the Bank Conservation Act. We are currently researching what other changes, if any, would be required. We would be pleased to work with the Committee in exploring this idea further.

More flexibility is also needed in the handling of closed banks. In particular, there are instances where state branching restrictions impede a resolution of a failed bank by discouraging bids by out-of-state holding companies. The extraordinary acquisition provisions of the Garn/St Germain Depository Institutions Act of 1982 should be expanded to allow an out-of-state holding company that bids to acquire a failed

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bank to acquire the entire holding company of that bank and not just the bank, as is currently the case. Such an amendment would remove the disincentive for out-of-state holding companies to bid in those states that restrict branching but permit multiple bank holding companies.

Finally, we do not have sufficient flexibility to deal with changes in bank control. Under the Change in Bank Control Act, we cannot impose conditions necessary to ensure safety and soundness as we can when we charter a new bank or approve a merger. We can only disapprove notices and must do so within unreasonably short timeframes. In addition, we lack adequate investigative authority. We believe legislative action is required to provide us increased flexibility under the Act.

CONCLUSION

Mr. Chairman, this is surely one of the most challenging periods the banks, the supervisors, and the Congress have ever faced. You have a unique opportunity to address the major policy issues that are prevalent in today's financial environment, and to thoughtfully legislate solutions that will provide the American citizen with a strong and responsive financial system.

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We must work together to take a comprehensive approach. As you have recognized, the issues are neither singular nor free-standing. We must make progress on three fronts. As banks gain the necessary flexibility through deregulation to meet marketplace demands, the roles of deposit insurance and supervision must also be reviewed. The reform of the deposit insurance system must have as its goal the encouragement of public confidence in the banking system and the furtherance of market discipline. Finally, supervision must adapt to the increased complexity of the financial system by acquiring the necessary tools to better anticipate and deal with emerging problems.

We now have the opportunity to formulate and implement important reforms of the financial system. It will not be an easy task, but let us not forget that the continued health of the banking system, and the role it plays in our nation's financial and economic life, is at stake.

* * *

I would be happy to answer any questions you or other members of the Committee might have.

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The CHAIRMAN. Thank you, Mr. Selby.

This morning while you have been sitting there listening to the testimony of Chairman Isaac and the questions, a good deal of it centered on how we determine risks and an argument over risk categories. Also, we discussed the number of failed banks within those categories who are in the 4 and 5 rating and subsequently failed.

Now, I assume that Mr. Isaac's figures are correct and I assume that Mr. Cates' figures are correct. It's the same old story. After 10 years of listening to statistics in this committee, everybody always presents accurate statistics. It depends on what viewpoint, what base they're using, and all of that.

But what is your opinion as a regulator of the whole assessment of risk? Mr. Cates can say you should only include 4 and 5 and Mr. Isaac makes, certainly from his point of view, a valid position that you've got to consider 3, that they're troubled institutions as well. What kind of game are we playing with numbers anyway?

Mr. SELBY. Well, I guess I can throw out some additional numbers if you'd like.

The CHAIRMAN. I have no doubt that you could.

NOT INTENDED TO BE A PREDICTOR

Mr. SELBY. First, I'd like to say, though, when you're talking about CAMEL ratings, CAMEL ratings are not intended to be a predictor. CAMEL ratings are a summation of what we find about the condition of the bank at the end of an examination. One reason they are not necessarily a predictor of failure is we do not change the CAMEL ratings between examinations. While we do have considerable off-site analysis of financial data and other information between examinations, that alone doesn't key into a change in the CAMEL rating. If we find a serious problem in our analysis of off-site monitoring information, then we promote an examination to find out the cause. And if that examination produces different results, than the previous examination, that is when the CAMEL rating is changed.

Mr. Cates, as you may know, has a larger predicted failure rate than we do. He predicts that some 40 percent of his sample are subject to failure. I think Mr. Isaac mentioned that perhaps for Mr. Cates' purposes, his 40-percent calculation is adequte. For our purposes, however, to consider taking 40 percent of the population of banks that we supervise and consider them potential failures—I don't think we have enough people to provide that kind of supervisory attention. Quite frankly, I think our system has to be a little more refined in terms of predicting failures.

Now I said I was going to give you some statistics and I will, on national banks only. I think the figures that Mr. Isaac and Mr. Cates were quoting have to do with the CAMEL ratings at the last examination prior to failure. Mr. Isaac is correct, since the CAMEL rating was instituted we have considered banks subject to special surveillance those rated 3, 4, and 5. We compiled some statistics on national banks failing between 1981 and 1984 and for those national banks, 2 years before failure we had rated 46 percent of them 3,

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4, and 5; 1 year before failure, it jumps to 71 percent, and 6 months before failure, 91 percent.

The banks that failed but were not rated 3, 4, or 5, although we haven't researched it, probably deteriorated due to items that may not be predictable through any kind of financial analysis. Massive fraud, for example, can close a bank overnight.

NEED OF COMPREHENSIVE UP-TO-DATE INFORMATION

The CHAIRMAN. In your statement you stress the importance of having comprehensive, up-to-date information. Certainly I can't disagree with that in attempting to make decisions, but you mention that you are not always able to obtain that kind of information.

What factors constrain your efforts to get adequate information to make decisions on?

Mr. SELBY. Well, there are several areas that I was thinking about. One, I think the agencies themselves can do more than they do now. We react a little slowly to information that we need. We have to go through the FFIEC and agree among ourselves what kind of changes are to be made to the call reports. When you have several agencies deciding what information is required, sometimes it's difficult to decide among ourselves what is more important. I think we can react a little more quickly than we have in the past.

There are some problems that I think perhaps cannot be solved, whether it's through congressional action or by the agencies. The June 30 call report, for example, is not required to be reported until 30 days later. Yet, we can pick up the local newspaper, particularly on the larger banks, and read of their earnings figures for the June 30 quarter way before we get the figures. Once we get the figures, we have to load the information in computers and check for accuracy. As a result, the June 30 figures will probably not be available to the agencies until mid-September. And that is just not a very timely process for us to obtain financial data to perform analyses.

I think if we had a wish list of things that might be improved it would be to give us the ability to react a little more quickly. For example, if we feel something is important enough to warrant monthly reporting by banks, that we would have the ability to more quickly ask for a different type of reporting. I understand that the paperwork burden is something that Congress is worried about, and we are, too, but I think there may be instances where we, as a regulatory agency, should be able to make a determination that some information is needed more quickly than can be collected by going through the current process.

The CHAIRMAN. In your testimony you advocate the provision of greater powers for the Office of the Comptroller and other regulators to deal with banks that are still open but probably will not to be viable over a longer period of time.

How would you make that kind of determination and what limits would you place on those kind of powers in order to protect the rights of the shareholders?

Mr. SELBY. Well, that's important. That's why I said that we haven't completely formulated what our final recommendation would be and once we do we would be pleased to give that to you.

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But the difficulty we experience now, as I said in the testimony, is that we, have only two methods of actually disposing of a bank, and can only do so when it fails. That is, we close a bank when it becomes book insolvent, that is, when the liabilities exceed the assets, or when it experiences a liquidity insolvency, i.e., when there are no funds available to pay depositors. By that time, we have not protected the FDIC fund, nor have we protected the investors or the depositors to the extent that we could if the regulators were given a little more flexibility. As I said in my testimony one idea we would like to pursue is if capital drops some level where we believe the bank has little real capital, we would have the authority to take action such as creating a conservatorship.

The CHAIRMAN. Would increased liability for bank directors in the event of fraud and gross mismanagement and so on be a deterrent not only for their misfeasance of bank directors but getting them more involved in what is going on?

Mr. SELBY. We have considered whether there might be some additional statutory powers to increase directors' liability. We have concentrated our enforcement effort to hold directors accountable. We have used our civil money penalty power extensively to assess directors and hold them responsible. That is not for fraud obviously. That is for wrong decisions or mismanagement.

My initial reaction was that increased statutory powers might be a way to make the directors more liable, and might increase their response to their obligations within the bank. It's a very serious thing to do, however, to think about increasing liability of a group of people.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Mr. Selby, on June 28, the Wall Street Journal carried an article headlined, "Foreign Banks Step Up Lending Competition in the U.S. and Abroad." This article contends that Japanese, British, West German, and other banks are taking foreign and domestic loan business away from the United States banks. It says that U.S. bankers complain that their competitors have an advantage because foreign regulators permit greater leverage, that is more loans in relation to the bank's capital. The extra leverage enables them to charge lower interest rates than the U.S. banks do and still earn just as much money as a percentage of total capital.

The article goes on to note that part of the reason for the higher capital ratios being required in U.S. banks is the Latin American debt crisis.

On page 12 of your testimony you commend Congress for specifically authorizing regulators to require higher capital ratios when Congress passed the International Lending Supervision Act of 1983.

COMPETITIVE DISADVANTAGES OF U.S. BANKS

My question is the following, and I'll ask each of them in turn. First, could you give us your views on whether U.S. banks are being competitively disadvantaged by the recent emphasis on higher capital ratios?

Mr. SELBY. I don't think they are. That is a fairly common claim. I happen to have considerable dialog with the foreign supervisors,

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particularly through the BIS in Basel, Switzerland, and I haven't found one foreign supervisor that is not concerned about the levels of capital of their banks. Indeed, a lot of the things that we study are the questions that worry us in the United States—liquidity levels of the banks, capital levels of the banks, off-balance sheets items. The only thing that I would say is that there perhaps are countries where the government is so influential in controlling the banking system and not requiring higher levels of capital—Japan being one of those—that they may prevent the United States banks from being competitive for loan business.

But I do not think it's a serious problem and I think there are plenty of loans available for the domestic banks to participate in.

Senator PROXMIRE. Where there is a disadvantage—and you say in Japan there may be—is that something that American banks will just have to put up with because of the situation they've gotten themselves into because of their riskier loans?

Mr. SELBY. You mean they can't compete because of their riskier loans or they'll just have to put up with the way Japan does business?

Senator PROXMIRE. That's right.

Mr. SELBY. I assume they will have to put up with the way Japan does business unless the Japanese authorities change it.

Senator PROXMIRE. I take it you feel that the foreign bank regulators should and in most cases are also demanding higher capital ratios; is that right?

Mr. SELBY. I think most of them are very cognizant of it and working on it. There are some very severe difficulties, Senator, in trying to arrive at some common capital standards among all of the countries. You were discussing with Mr. Isaac the question of market value accounting. Lots of countries allow banks to hold hidden reserves, which means that their assets are worth a lot more than what is reflected on their balance sheets.

Senator PROXMIRE. Now you're familiar with this. You have had a lot of experience with it. Are you or our other regulators working internationally to achieve some kind of consensus on the issue of capital adequacy so you have a similar policy which would eliminate any inequity in competition?

Mr. SELBY. The Federal Reserve, the FDIC, and ourselves are all members of a committee of the BIS. I've been serving on it now for 2½ years, and one of the goals of this committee is to study whether we can arrive at a consensus on a capital standard.

Senator PROXMIRE. And you think you're making progress?

Mr. SELBY. I think we are making progress.

Senator PROXMIRE. During 1979 the Federal Reserve and the FDIC joined the Office of the Comptroller in establishing the Interagency Country Exposure Review Committee [ICERC], which meets three times a year to assess the country risk where our banks have outstanding loans. It categorizes countries on their ability to repay U.S. banks. There are seven different categories, the lowest two of which are value impaired and loss.

Under ICERC procedures, the country gets the value-impaired rating when the country has not fully paid its interest for 6 months.

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Now in June of this year, ICERC met and there was speculation it would label bank loans to Argentina as value impaired because of the delinquency on interest payments on such loans and thus require the banks to set up the special reserves required by the International Lending Supervision Act of 1983 against such loans.

On June 26, the Wall Street Journal carried an article which said that after the June ICERC meeting, the regulators issued a directive that "banks should utilize conservative treatment of interest payments received from Argentina."

The article noted that bankers say they are not sure exactly how they are to implement the directive.

My question is, did ICERC recommend that the bank loans to Argentina be categorized as value impaired and recommend that special reserves be established against such loans and if ICERC made such a recommendation, did the regulators accept it? If not, why not?

DEFER CONSIDERATION OF ARGENTINA

Mr. SELBY. No, there was no such recommendation made. The committee voted to defer consideration of Argentina until a later date, presumably at the October meeting in light of the considerable efforts being made by all parties including the IMF and the same advisory group to bring about a solution to Argentina's financial problems. The Government of Argentina itself took extraordinary actions to put into place a mechanism to permit orderly repayment of its considerable debt. Six month's arrearage is only one criterion used to determine whether a country should be placed in value impaired. The committee must consider actions taken by the country to resolve its debt problems, status of IMF negotiations, and willingness of governments and banks to support the efforts being taken.

Senator PROXMIRE. These were extraordinary austerity measures, maybe unprecedented.

Mr. SELBY. In my view they were extraordinary.

Senator PROXMIRE. They were extreme.

Mr. SELBY. That's correct.

Senator PROXMIRE. If it didn't make the recommendation, do you think it should have made the recommendation that Argentina be consider value impaired? What's your view?

Mr. SELBY. I think the committee made the right decision to defer a final vote on Argentina until it is clear whether remedial actions being taken will be successful.

Senator PROXMIRE. You think the Argentina situation is still in balance and it will take a little while before we know?

Mr. SELBY. That's correct. I think the committee also recommended that because there were certain efforts being undertaken such as the expected signing of the agreement with the IMF, the expected payment of some interest, arrearages, and the agreement among many creditors to support the Argentine loan package, these initiatives should be permitted to be followed through and monitored. Failure by the Argentines to follow the prescribed course of action would cause the committee to reconsider the Argentina vote at any time before their October meeting.

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Senator PROXMIRE. Well, should the banks be putting special reserves behind those Argentina loans under the circumstances?

Mr. SELBY. Well, our own rules would not necessitate reserves at this time. We believe that most banks already have, quite frankly, reserved against Argentina as well as other countries, and we certainly would encourage them to keep building their reserves. We did not mandate that banks set aside a prescribed reserve for Argentina. We did think that during the interim, until the outcome of existing negotiations was clear, it was important for the banks to follow prudent and conservative accounting practices.

Senator PROXMIRE. You see, my problem is that the directive seemed so vague and generalized. What does the directive "banks should utilize conservative treatment of interest payments received from Argentina"—what does that mean? What do they do?

Mr. SELBY. It means they should be conservative in accounting for interest payments received. Until Argentina demonstrates a willingness and ability to meet debt payments, it is most conservative to place income received into a reserve account. That's what we suggested, that the banks segregate income any way acceptable to the regulations including an interest reserve, placing income into a deferred income account, but not, putting interest received into their earnings streams.

Senator PROXMIRE. Mr. Selby, I'm having a little trouble sorting out your views on capital standards and whether they are in conflict or complementary to Mr. Isaac's.

You emphasize we need to move toward a minimum 9 percent capital ratio with up to 3 percent in subordinated debentures—I should have said that Mr. Isaac takes that position.

You argue that any capital ratio should be based not on total assets but on the riskiness of those assets. Presumably a bank that puts all its money in T-bills needs less capital than one that puts it all in shopping center loans.

Can these two approaches be reconciled or are they mutually inconsistent?

Mr. SELBY. Well, let me clarify. We are working on risk-based capital standards, and as I said so are many foreign supervisors. However, I would never intend for the risk-based capital standards to replace the capital-to-total assets. It would supplement it. I think we need some minimum capital based on total assets. So I am not in disagreement with Mr. Isaac. That might be 9 percent. It might be the present 5.5 percent. It might be something in between. But I think it's more important for us as regulators and supervisors, once we have set the minimum capital, to address ourselves to the risk that's contained in the bank and whether they need more capital.

I also mentioned in my statement, that since we established the capital-to-total asset ratio of 5.5 percent uniformly, we have seen banks decrease the amount of their liquid assets because they obviously make less money on them than on the higher risk assets that they can invest in. As a result, their liquidity has gone down to what I think are unacceptable levels. And that's something that is a threat to the insurance fund because if they don't have liquidity and if there is any loss of market confidence in the bank, the FDIC indeed is going to have a bank on their hands.

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The second thing is that to maintain a capital level of 5.5 percent and still participate in growth, banks have gone off-balance sheet to fund the growth, and we don't capture off-balance sheet items in our 5.5 percent ratio.

SIGNIFICANT DANGER OF BROKERED DEPOSITS

Senator PROXMIRE. Just one more question, Mr. Selby. Both Chairman Gray and Chairman Isaac have argued that brokered deposits pose significant danger to the health of our banking system. Chairman Gray even calls them a cancer on the thrift industry. Former Comptroller, Mr. Conover, by way of contrast, has said not to worry, that brokered deposits were OK, although some upper limits on them may need to be established.

How do you account for the radically different assessments of broker deposits by your agency and the two insurance agencies? You both have access to the same data. How do you come up with such widely different conclusions?

Mr. SELBY. Well, not to be flip, it may be the difference between a regulator and an insurance agency. I don't know.

I don't say that the business of brokered deposits is not something that should be addressed. Perhaps it has increased the cost to the Federal Deposit Insurance Corporation, as well as the FSLIC. But what we have said is, don't throw the baby out with the bath water. The whole business of brokered deposits serves several good functions for this country. It provides deposits in areas that need deposits to meet credit needs of smaller communities across the nation. That's a good thing, to reallocate the base for lending.

As a matter of fact—I didn't bring the statistics with me—I testified last week before Congressman Hubbard on brokered deposits, I stated there that retail or insured brokered deposits are very small in relation to total brokered deposits. Over 2 years ago we initiated a policy where our enforcement actions contain a clause relative to brokered deposits, whether it's a problem or not a problem. It can range anywhere from our monitoring brokered deposits to telling the banks to eliminate brokered deposits.

I understand the insurance concerns, and if the abuses do cost the insurance fund money, then it's something that, the abuses should be stopped.

Senator PROXMIRE. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman.

Mr. Selby, the minimum capital requirements, what were they 25 years ago?

Mr. SELBY. Well, 25 years ago——

Senator HECHT. I'm just trying to get it in my mind.

Mr. SELBY. Quite frankly, I've been with the Comptroller's Office for 32 years this month and up until 1980, I can't remember where we ever had a policy that set minimum capital requirements. Now there was always a kind of a rule of thumb that said capital should be 7 percent or 6 percent or——

Senator HECHT. Or 8 percent.

Mr. SELBY. Or 8 percent. As I recall, it was mostly 7 percent as a rule of thumb.

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Senator HECHT. How did you come up with 5.5 percent?

DEFFERENT STANDARDS FOR DIFFERENT SIZED BANKS

Mr. SELBY. How did we come up with 5.5 percent? In 1980, I believe, the Federal Reserve and the OCC for the first time developed capital standards and guidelines for our banks. The FDIC did not join us in that. At that time, we had different standards for different sized banks. We actually had three categories of banks, and we put different capital standards on them.

Senator HECHT. What were the three groups?

Mr. SELBY. The community banks, the regional banks, and the multinational banks.

Senator HECHT. Was there a dollar limit in there?

Mr. SELBY. No dollar limit, no.

Senator HECHT. What were the footings of the banks in these three different categories, average?

Mr. SELBY. The multinationals were over $10 billion. The regionals were $1 to $10 billion, and the communities were under $1 billion.

Senator HECHT. OK. Thank you. No, go on.

Mr. SELBY. But we had also, the Federal Reserve and ourselves, established a two-tired capital standard. One was primary capital. That was equity, more or less, and then we counted subordinated debt in the total capital computation. The FDIC had never recognized subordinated debt capital before. So when we met with the FDIC and the Federal Reserve and went through this process, we had decided that the bottom one should be raised and the top one should be lowered to reach a minimum of 5.5 percent for primary capital and 6 percent for total capital.

Senator HECHT. What was the bottom at that time?

Mr. SELBY. The bottom was 5 percent at that time.

Senator HECHT. The bottom was 5 and the top was how much?

Mr. SELBY. The top at that time was 7, I believe.

Senator HECHT. So you have lowered the top and raised the bottom, and what was the one in the middle?

Mr. SELBY. The one in the middle was 6.

Senator HECHT. And you came out with 5.5?

Mr. SELBY. And 6 total.

Senator HECHT. So what is it now?

Mr. SELBY. 5.5 primary, 6 percent total.

Senator HECHT. Do you feel that's a good figure?

Mr. SELBY. Every bank has to have 6 percent in total capital. They can meet that 6 percent total capital either all in equity or 5.5 percent in equity and one-half of 1 percent in debt.

Senator HECHT. Are you comfortable with that figure?

Mr. SELBY. With the percentages? I'm comfortable with it now. I would like to see, as I said, some increased attention paid to a risk-based capital computation. Our current requirement is a minimum, however. We established that as a minimum for all banks. There are any number of banks that we individually address on the capital issue. When Congress gave us the ability for the first time to enforce capital standards in the International Lending Supervision Act, we developed regulations that provide for the use of capital di-

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rectives. These are enforceable documents which we put on banks when we want more capital if they are not willing to raise their capital. And I would say that we have lots of banks where we require higher capital than 5.5 or 6 percent.

Senator HECHT. Are you in favor of moving up the next few years?

Mr. SELBY. To additional capital?

Senator HECHT. Yes.

Mr. SELBY. Well, I'm in favor of taking what we have now and determining the operations of the bank and the concentration of its risks and imposing additional standards on that bank if it has what we consider undue risks.

Senator HECHT. In what ways do you recommend for banks to meet these capital requirements? Sell stock?

Mr. SELBY. They can sell stock. They can sell subordinated debt. They can retain earnings and it may be that to retain earnings you have to limit dividends.

Senator HECHT. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Selby, I'm wondering how many banks at the present time hit that 5.5 percent mark?

Mr. SELBY. How many hit it?

Senator D'AMATO. Yes. What percentage would you say have qualified and do have 5.5 percent?

Mr. SELBY. It would be a sheer guess as to what percent would be at 5.5. I would suspect that a vast majority are at 5.5.

Senator D'AMATO. Really?

Mr. SELBY. A vast majority. We have been very successful. The banks in the country with the lowest capital were actually the large money center banks, and we have been successful in raising capital in every multinational above the 5.5 percent mark.

Senator D'AMATO. That's where I was going.

Mr. SELBY. Right.

Senator D'AMATO. Do you consider 5.5 percent to be the minimum?

Mr. SELBY. The minimum.

Senator D'AMATO. And you say now that every money center bank or multinational is up over that 5.5 percent?

Mr. SELBY. I believe that's correct.

Senator D'AMATO. Or the majority?

Mr. SELBY. I believe all of them are.

Senator D'AMATO. Now would you feel more comfortable if they had it above that 5.5 percent?

Mr. SELBY. Some of them, of course, and in those cases we have required the bank to have more than the 5.5 percent minimum. There are others where I think 5.5 percent is adequate right now based on their performance, management, quality of assets, and their business product line.

Senator D'AMATO. In talking about assets and liabilities, how do you rate, for example—what category do you put in loans to Brazil? What do you say about that?

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Mr. SELBY. What category is Brazil in? Well, we have, as Senator Proxmire said, certain categories based on standards that the ICERC Committee has developed. I don't recall the category Brazil is in.

ADDITIONAL RESERVES FOR FOREIGN LOSSES

Senator D'AMATO. Let me put it another way. I know that in certain cases that you've been recommending the banks put aside additional reserves specifically to handle the outstanding indebtedness, whether it be energy loans or whether it be as a result of foreign loans. Could you describe to me what process you go through and what predicates your move toward let's say telling X, Y, Z bank that you want to see additional reserves set aside for loan losses? Because I see this huge problem out there and I hear various world leaders, like Fidel Castro, saying to Central American and South American nations, "Why don't you just tell them we're not going to pay your debt." I'm wondering how we react to that and how serious those implications are. How do we move to deal with that?

Mr. SELBY. Well, determining the appropriate level of reserves is not a precise art. What we have been doing for a number of years is to assess the bank's own ability to reserve adequately based on their own systems after determations of quality of their assets and the risks in their portfolio.

We still do that, and we have found for the most part those systems to be efficient. What we try to do, although as I said it's not a precise art, is to judge the quality of their assets, their own internal appraisal systems of quality, and then assess whether loan loss reserve, in effect, covers the total risk in the portfolio. We think all risk in the portfolio must be covered.

Now having said that, you have to determine layers of risk and you have to make arbitrary decisions as to what percent should be allocated against that risk.

Senator D'AMATO. Well, let me give you an example that comes to my mind. Take the Polish debt for instance. I don't know how much of it is our large money center banks loan, but it runs into the billions of dollars. Is that true or not?

Mr. SELBY. I don't know about the Polish debt, but I would say it's large.

Senator D'AMATO. Now if you take a look at that as a practical matter, how do you view that? How do you treat that? It's involved in almost a big Ponzi scheme you know. I know there's a reluctance to start, in the technical jargon, to write off these debts or discount them, but it would seem to me we had better begin to undertake that and then at some point in time, you know, when you're able to collect something on them, that's fine, but aren't we kidding ourselves if we don't take that action?

Mr. SELBY. Well, it is not only the Polish debt we specifically had the banks reserve.

Senator D'AMATO. That's bad. I'd like to hear about that. Tell me about that.

Mr. SELBY. Well, the commitment that——

Senator D'AMATO. What commitment?

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Mr. SELBY. A commitment that an interagency committee meet three times a year to look at the transfer risk, and then make a determination as to the degree of transfer risk present. This determination is made after reviewing economical data and obtaining the most current information.

We have set up categories where each country would fall, based on all the factors, whether the country is under the IMF adjustment program, whether they are in arrearages at present, whether they are making progress in their economy. All of these factors are considered. And once you categorize them, this affects the level of reserves required in a bank based on aggregate risk of the portfolio.

Senator D'AMATO. If you would take a couple of those countries, or large debtor nations and put them together in any one time, do you know of any cases where those large money center banks would be in a negative position where they would have no capital to offset that?

Mr. SELBY. You mean, charge them off?

Senator D'AMATO. Sure.

Mr. SELBY. Sure. Exactly right.

Senator D'AMATO. So, as a practical matter, we should begin to deal in those areas where there is less likelihood of these debts ever being paid back to build those reserves, we will begin to charge them off. Should we begin to charge them off?

Mr. SELBY. We are dealing with that issue. I think, if you will look at the reserves, particularly of national banks, you will notice a substantial increase in those reserves over the past few years. This increase should cover both the domestic and international debt.

Senator D'AMATO. Are we then charging those debts off?

Mr. SELBY. We are not charging them off. We are reserving against them. I don't know how you can charge off a country's debt unless they completely repudiate the debt.

Senator D'AMATO. Well, as a practical matter, in some of those situations, the likelihood of repayment is——

Mr. SELBY. It really doesn't make any difference if you allocate reserves against those debts or whether you charge it off. The end result is right. You have reserved against those debts.

Senator D'AMATO. Mr. Chairman, I think it would be interesting if you could submit to the committee exactly how much has been reserved specifically for foreign debts that you are required to set aside, and what we are talking about in actual dollars? Is it possible to talk about that figure?

Mr. SELBY. I don't know that it is.

Senator D'AMATO. Well, if you, for example, have decided X, Y, Z bank should put aside so much——

Mr. SELBY. We would apply it to the bank and assess the aggregate risk.

Senator D'AMATO. Well, assume, taking into consideration, Mr. Selby, the nature of the total debt portfolio.

Mr. SELBY. Yes.

Senator D'AMATO. And then you look at that area, which is set aside for some of the foreign loans.

Mr. SELBY. I can give you the Polish debt reserve.

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Senator D'AMATO. Can you give us all the other countries they're reserved to?

Mr. SELBY. We have specifically required allocated reserves on Poland and some other countries.

FOUR OTHER COUNTRIES LISTED

Senator D'AMATO. What are the other countries? Would you tell me the other countries?

Mr. SELBY. Zaire, Bolivia, Nicaragua, the Sudan.

Senator D'AMATO. Those are the four today?

Mr. SELBY. Those are the five.

Senator D'AMATO. Five. Would you give us those figures?

Mr. SELBY. Yes.

Senator D'AMATO. Thank you very much. When will we get those figures?

Mr. SELBY. As soon as I can get them.

Senator D'AMATO. Well, how long would that take? About 1 week?

Mr. SELBY. You're asking for the national banks, is that correct?

Senator D'AMATO. Sure.

Mr. SELBY. Since I don't supervise the State banks.

Senator D'AMATO. Right. National banks.

Mr. SELBY. We probably can get that to you maybe the end of this week.

Senator D'AMATO. Wonderful.

[This matter was discussed with Senator D'Amato's staff.]

Senator HECHT. Senator, would you yield one point?

Senator D'AMATO. Certainly.

Senator HECHT. May I ask one other question on the same line? What is the dollar amount that went for 90 days or more?

Senator D'AMATO. Could you give us the dollar amount delinquent?

Mr. SELBY. I think so.

Senator HECHT. Thank you, Senator.

Senator D'AMATO. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Selby.

[Response to written questions follow:]

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN
FROM
H. JOE SELBY, ACTING COMPTROLLER

Comptroller of the Currency
Administrator of National Banks

1. Should a federal insurance agency be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed institution with any profit after administrative costs arising from the transaction returned to the original stockholders?

We agree that regulators need greater flexibility in handling failing banks in a way that minimizes the cost of failure. Currently, supervisors can take only limited action to resolve a problem bank situation before insolvency.

Ideally, a failing bank would be closed at exactly the point of true economic insolvency. At this point, shareholder equity would be exhausted. Closing a bank prior to this point could invade the rights of shareholders, while waiting longer would lead to losses for the FDIC and other creditors and uninsured depositors. However, closing a bank at this ideal point would require precise measurements of the value of a bank's assets, either in liquidation or if the bank were to be sold as a going concern. Thus, book capital would have to be adjusted for credit quality, interest rate risk, and other, less tangible criteria such as the value of the bank's customer relationships. Because of the difficulty in making such measurements in a timely and accurate manner, banks are frequently closed at a point after real capital has been exhausted, and, as a result, the FDIC and other creditors typically suffer a loss.

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Such losses could be minimized if the regulatory agencies were provided with expanded authority to deal with open banks that are determined not to be viable over the long-term. Two suggestions that we offered in our written testimony include authorizing bank supervisors to direct bank owners to merge or liquidate a bank when capital falls below three percent (the level at which the FDIC generally considers termination of deposit insurance), and empowering the primary supervisor to appoint a conservator to exercise the full range of powers possessed by bank management, including the sale of the bank.

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2. If the burden of mismanagement were placed squarely on the managers and stockholders and most failures were handled through a purchase and assumption at an earlier stage - immediately or through a conservatorship - regardless of size - wouldn't this dispose of the fairness question as it relates to large and small institutions? Why couldn't a Continental type solution be applied to failing small banks? If an insurance agency is funded totally by institutions is there a federal subsidy?

Closing all banks at the point of economic insolvency and handling them by a full purchase and assumption would, in fact, dispose of the fairness question. Only shareholders would bear losses. All depositors and other creditors would be made whole and the FDIC would have no losses because the value of the failed institution's assets would just equal the value of its liabilities. However, as we discussed in Question 1, determining real capital insolvency is extremely difficult, and as a result most bank failures involve losses to the FDIC. In those cases, the use of full purchase and assumptions, by protecting uninsured depositors and other creditors, reduces the incentive for the private sector to monitor the condition of banks. Because market discipline by uninsured depositors is a potentially powerful means of controlling risk in the industry, mechanisms that meet the fairness criterion and maintain incentives for market discipline, such as the use of modified payouts on all size banks, need to be developed and implemented on a broader scale.

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It is impossible to ascertain whether federally insured institutions receive a federal subsidy. Institutions pay directly for federal regulation, supervision and insurance through assessments and insurance premiums, and indirectly by meeting certain reserve and reporting requirements. In return, they receive not only tangible benefits (such as examinations) but also many intangible benefits afforded by the federal safety net. Because the dollar value of these costs and benefits can not reliably be assigned, there is no way of determining which is greater.

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3. What can be done to prevent covenants in subordinated debt agreements from requiring the FDIC to prevent losses to all creditors as well as the holding company?

Covenants in subordinated debt agreements are essentially provisions in private contracts between debt issuers and debt holders. Such covenants frequently limit the flexibility of the debt issuer to take actions that could impair the position of the subordinated debt holders. For example, they may take the form of restrictions on the dilution of a bank holding company's interest in a banking subsidiary or on the issuance of long-term debt that would be senior to the subordinated notes containing the covenants. The following are possible methods of preventing the FDIC from being bound by such restrictive covenants and thereby being forced to take actions which would protect all creditors of a bank as well as its holding company:

(1) Legislation could be enacted which would exempt the application of such covenants to the FDIC when such covenants inhibit the FDIC's efforts to provide a statutorily authorized assistance package. Because the validity of contracts and their component covenants are determined by the laws in force at the time of the contract's execution, it is

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questionable whether subsequently enacted legislation would effectively prohibit enforcement of the contract or its covenants.

(2) The regulatory agencies could use their rulemaking authority to issue regulations similar to the legislation discussed above, but the application of such regulations to pre-existing debt would raise questions of constitutionality and be subject to closer judicial scrutiny than legislation enacted by Congress.

(3) The Federal Reserve Board could exclude subordinated debt that contains undesired covenants from being considered holding company capital, either primary or secondary. The OCC and the FDIC could do the same for bank capital. While this would not prohibit banks or bank holding companies from issuing subordinated debt with restrictive covenants, it would substantially reduce their incentive to do so.

It must be recognized, however, that the implementation of any of these alternatives may make it more difficult, or more costly, for banks and bank holding companies to issue subordinated debt.

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4. Is there a place for self-regulation in the banking industry that draws on the talent within the industry? If so, how could concepts of self-regulation be included in the federal supervisory system?

Yes, there is an appropriate place and a need for self-regulation in the banking industry. The talent for such an undertaking is available from within the industry, and could take more than one form. Nonetheless, we do not feel that self-regulation could fully replace the current system of supervision.

One example of self-regulation would be an industry-wide code of ethics, established and implemented through a nationwide effort, that could provide a basis for uniform evaluation of actions by banks and bank officers. It could be contained within a national trade organization, eliminating the need for a separate new organization.

Another, perhaps complementary, measure would be the establishment of an industry standards board. Uniform standards could provide significant assistance to the regulatory agencies, providing an explicit, industry-stated position to assist in judging unsafe and unsound actions. Failure to act in accordance with such standards could trigger supervisory actions, e.g., removal, cease and desist and civil money penalty actions, providing the courts with "industry-established standards of conduct".

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The establishment of an industry standards board is a major undertaking that has proved effective in other industries. To work, it would need the support of the members of the industry, with its functions consolidated in one operation acceptable to all banks. To have maximum effectiveness, the board could be organized along functional lines, e.g., trust, mortgage banking, investment portfolio, commercial lending, and the like.

Although self-regulation is an appealing concept, establishment of a meaningful program within the banking industry is not without problems. First, the resource commitment needed to develop an acceptable self-regulation plan for the industry could be substantial.

Second, such a program will not voluntarily arise unless it has the realistic potential of supplanting, to some extent, current regulatory or supervisory functions conducted by the agencies. Although we would support any efforts undertaken by the banking industry to develop a self-regulatory process, we cannot commit to specific reductions in our regulatory or supervisory responsibilities without a great deal of further study.

We would, however, look favorably upon using industry-established standards to supplement our own in any upcoming regulations we may need to establish. In that way, banking industry initiatives in the self-regulatory area could substitute for more detailed regulatory prescriptions.

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5. What is your view of Mr. Keefe's suggestions that

   a. The current loan limit is too high?
   b. Many banks fail due to excessive concentration?
   c. A bank be required to list its 30 largest borrowers by type of company?
   d. The largest banks be required to supply regulators with monthly data?

We are comfortable with current national bank lending limits. They are low enough to prevent individuals and groups of individuals from borrowing an unduly large amount of a bank's funds, and thus ensure that a bank's loan portfolio is adequately diversified across individuals.

However, lending limits do not, nor are they intended to, address industry concentrations. Industry concentrations alone do not cause bank failures. Most banks fail for a combination of reasons that include mismanagement, poor loan quality, and, in many cases, fraud. While all banks should have the freedom necessary to diversify, it would be inappropriate for us to determine a bank's lending strategy. It is our job to ensure that banks take appropriate safeguards against the risks associated with the loans that they make. In particular, national bank capital levels are expected to reflect risk in the loan portfolio. The OCC is currently studying ways this concept can be formalized through risk-based capital requirements.

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The suggestion that a bank be required to list its 30 largest borrowers by type of company is worthy of consideration. We support expanded disclosure of data pertinent to a bank's condition. In that respect, data on industry concentrations would be relevant. In fact, our proposed disclosure regulation requires banks to report concentrations of credit. However, names of specific borrowers may not be appropriate for government-mandated disclosure.

We would like to be able to request data from the largest national banks at any time, to complement our almost continuous on-site presence in those banks. Increasingly, our banking environment is one in which changes can occur rapidly. As a result, supervisors have a growing need for timely information. Moreover, increased use of computers and more sophisticated management information systems make gathering and timely reporting of data easier for banks. We are currently exploring the possibility of tapping into portions of the management information systems of the largest national banks to provide us with continuous access to up-to-date data at minimal cost to the banks.

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6. Should CPA audits be required of all depository institutions and their holding companies? What steps, if any, should be taken that would permit federal bank examiners to place more reliance on auditors' evaluation of management systems and controls? Would this help examiners focus on asset quality, and bank risk levels, etc.?

We believe that all banks can benefit significantly from an annual audit performed by an independent accountant. Moreover, although they are not a substitute for bank examinations, external audits are helpful to examiners because they reveal useful information about banks' management systems and controls and thereby enable examiners to devote additional time to other critical areas.

The majority of national banks already receive an external audit. We have recently instituted a number of policies aimed at further increasing the number of banks receiving audits. These include:

- Requiring newly-chartered banks that are not members of an audited holding company to obtain an annual external audit because of the higher degree of risk that new banks generally experience.

- Selectively requiring audits of problem banks that exhibit poor internal controls or other conditions that indicate that an audit would benefit the bank.

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- Requiring the board of directors or audit committee of all national banks to analyze the adequacy of the external audit coverage in their bank, and if an external audit is deemed unnecessary, to document the reasons with board or committee minutes.

We do not feel additional requirements regarding audits are necessary at this time. These initiatives should substantially increase the number of national banks receiving an annual audit. If we are not satisfied with the outcome of these initiatives, we will consider issuing a regulation.

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7. Would you recommend that federal depository agency personnel be exempted from government pay ceilings? If so, how can this be effectuated?

Yes. As I discussed in my full statement, the quality of our supervisory efforts depends on our having capable and experienced personnel. Unfortunately, the long-term compensation prospects for examiners who have completed extensive training do not compare favorably with those in the banking industry. Each year a number of mid-level and senior examiners leave to take positions with banks.

Efforts undertaken by other regulatory agencies to expand their examination forces have also put added pressure on the OCC. The financial regulatory agencies are statutorily exempt from government salary restrictions, but this flexibility has not been consistently applied. For example, FDIC examiners are paid in accordance with GS salaries, augmented by geographic differentials, but face no overall salary ceiling. OCC has a compensation program based on periodic surveys of salaries paid by national banks, but, as part of the Treasury Department, we have been administratively limited by the statutory pay ceiling and annual government comparability increases. The Federal Reserve Bank and Federal Home Loan Bank (FHLB) examiners are employed by their regional banks which, as private entities, determine their salaries. This discrepancy in

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earnings by examiners has put added pressure on turnover at the OCC, particularly in light of the FHLBs' recent efforts to expand their examination staffs.

Removal of the OCC's limitations on pay could be implemented through a program of market-based salaries and increases or bonuses. All of the other major financial regulatory agencies have programs currently in place that operate in that way.

8. What is your view of permitting federal regulators to require institutions to pay special assessments for the increased examinations made necessary by their classification as a problem institution?

We believe that the cost of regulation and supervision should be borne by those receiving the services. Therefore, we support permitting federal regulators to collect extra assessments from problem institutions because of the disproportionate share of regulators' resources they require. We also support authorizing the regulators to assess individuals whose actions lead to situations requiring an extraordinary expenditure of agency resources. We further believe that a system of special assessments in problem situations will add an element of discipline for all banks and deter unsafe and unsound activity.

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9. How can the bidding process be improved and the cost of managing a failure reduced?

The most direct way to improve the bidding process would be to remove some of the restrictions that currently limit the number of potential bidders. As I discussed in my testimony, there have been instances in which state restrictions have discouraged bids by out-of-state holding companies. If out-of-state holding companies that bid to acquire a failed bank were permitted to acquire the entire holding company rather than just the single bank, the number of firms submitting bids would likely increase. Such increased competition could be expected to increase the premium paid to the FDIC, thereby reducing its net cost of resolving a bank failure.

As discussed in the answer to Question 1 and in my testimony, another way to reduce the cost of managing a failure would be to take steps to close the bank immediately upon the exhaustion of its economic net worth, even if some book net worth remains. Such a practice would enhance the attractiveness of a closed bank to potential bidders.

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10. Should federal regulators be given any exemption from the burdens of the Paperwork Reduction Act? If so, when should they be exempt?

The OCC is sensitive to the recordkeeping and reporting burdens borne by national banks, and seeks to minimize those burdens. We have internal review procedures to ensure that new recordkeeping and reporting requirements are warranted when imposed, and that existing requirements are periodically reviewed and eliminated if no longer justified. Our record in securing the approval of the Office of Management and Budget (OMB) pursuant to the Paperwork Reducton Act for all information collections is testimony to our commitment to the ojectives of that Act.

Although the Paperwork Reduction Act has served a useful purpose, it would be appropriate to modify its application to the bank regulatory agencies. Banks operate in an increasingly dynamic environment, and bank supervisors are seeking ways to identify and respond to problems in a more timely manner. The OCC has developed, and will continue to develop, supervisory responses necessary to properly discharge its responsibilities. For example, we are placing increased reliance on use of available technology to both analyze pertinent information regarding banks and their financial condition and to target examinations on the

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basis of priorities of risks to banks and banking system. These supervisory procedures should result in more effective on-site examinations and thereby promote bank safety and soundness.

In today's fast-paced and increasingly complex financial environment, we feel it is important to explore possible changes in the Act relating to federal bank regulatory agencies. Under the Act, elaborate processes involving prior approval of information collections have developed for evaluating federal information collections. We are concerned that these procedures can lead to delays in gathering information relevant to the condition of the banking system and, thus, delay our supervisory responses to potential problems.

To eliminate unwarranted impediments to timely supervisory response by the bank regulatory agencies, it would be appropriate to exempt from the Act the collection of information that agency heads specifically certify are related to ascertaining the safety and soundness of commercial banks. Such an exemption would be consistent with other exemptions contained in the Act, in particular the exemption for administrative actions brought by the banking agencies which generally result from our examination efforts. Under this approach, we would continue to provide OMB annually with our information collection budget, including information collections the Comptroller has certified as addressing safety and soundness issues and the burden hours they impose.

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11. If regulators are rarely surprised by a bank failure - isn't the answer swifter or more appropriate regulatory action rather than increased market discipline? Wouldn't giving the regulators the ability to close an institution earlier be appropriate? Should a regulator require bank management to file a confidential bank failure plan approved by its board of directors if it falls a certain percentage below its minimum capital level for a specified period of time?

Regulators do act as swiftly as possible when they become aware of a bank's deteriorating condition. However, increased market discipline would help keep all banks healthy by increasing their sensitivity to risks associated with various undertakings.

Increased flexibility in dealing with problem banks, including the ability to remove management and to force the sale or merger of a bank when it nears insolvency, is highly recommended.

The suggestion that regulators require bank management to file a confidential bank failure plan is appealing, and consistent with our view that the bank itself has the ultimate responsibility for the outcome of its decisions. However, more thought would have to be given to what such a plan would contain, and whether the benefits of the plan would outweigh the costs associated with its preparation.

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12. What percent of total bank earnings are paid in deposit insurance premiums each year? Has this percentage gone up or down over time? Is there much variance bank to bank or by size of institution?

We defer to the FDIC in providing a detailed answer to this question. However, an example will illustrate the approximate impact of deposit insurance premiums on bank earnings.

The insurance premium rate of 1/12 of 1 percent of domestic deposits per annum is the same for all banks. What percentage of earnings the premium consumes varies according to bank earnings and liability structure. The average bank with assets of $100 million pays approximately $78,000 per annum for deposit insurance. Assuming the maximum 50% rebate (the actual rebate has been lower in recent years), the net cost is approximately $40,000 before taxes, or roughly $20,000 after taxes. The peer group average ROA for a bank of this size was .96% in 1984. Using this figure, assuming the rebate, and adding the net premium back into income, the net profit for the average $100 million bank is $1 million. Thus, approximately 2% of bank earnings are paid in deposit insurance premiums.

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13. There appears to be strong support for required risk-based capital - as a method of calculation of capital or as a supplement to the flat rate capital ratios. Would this necessarily lead to higher capital standards? Is there any need for legislation in this area if such risk-based standards were to be applied equally to all institutions?

Conceptually, risk-based capital requirements would not necessarily lead to higher capital standards. Capital requirements for some banks would increase, but for other banks, capital requirements could decline. Moreover, it would be possible to design risk-based capital requirements that would not require the industry as a whole to raise more capital.

The bank regulatory agencies have the authority to implement risk-based capital requirements. For such standards to be applied uniformly to all banks would require cooperation among the Fed, the FDIC, and the OCC, similar to that which led to the adoption of uniform capital requirements earlier this year.

Achieving uniform requirements for banks and thrifts, however, would be more problematical. Legislation mandating such cross-industry uniformity would probably be necessary. In light of the increasingly similar powers available to banks and thrifts, we believe that cross-industry uniformity would be needed to promote competitive equity.

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14. In 1981 and 1982, the banks and thrifts were suffering from disintermediation - their better customers were flocking to money market funds in droves. Now the concern seems to be that the higher quality loan customers are able to fill their needs elsewhere. The banks point to commercial paper, and the securitization of their loan portfolio. They claim that this trend is being caused in part by their capital ratios and reserve requirements. What is your view? What recommendations do you have for us in this area?

High quality borrowers that historically relied on banks to meet their credit needs now face a wide range of financing options. Some corporations find it less expensive to raise short-term funds by selling commercial paper rather than borrowing from banks. For example, an OCC study of the commercial paper market found that the interest rate on bank loans to corporations likely to have access to the commercial paper market was more than 86 basis points higher than the commercial paper rate.

The study also found that while total bank loans to corporate customers increased by $72 billion in 1984, commercial lending at the largest banks, those whose customers have access to the commercial paper market, fell by $5 billion. During that year commercial paper outstanding increased by $32 billion.

This development is, in part, attributable to capital requirements that do not account for differences in asset quality. If a bank incorporates the implied cost of

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capital into the price of a loan, it may find that its interest rate is not competitive with the customer's other financing alternatives. A capital requirement that recognized the lower risk in high quality assets would make holding the loan less costly for a bank and thereby enhance the bank's ability to offer an attractive interest rate.

Just as important, however, is the inability of banks to offer the full range of financial services to their customers. For corporate customers these may include investment banking services such as bond underwriting and underwriting the issuance of equity. As long as banks' activities remain restricted, it is likely that their best customers will continue to seek relationships with financial service firms offering a wider menu of products and services.

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15. With regard to the concern that some states may have expanded banks product authorities beyond what may be prudent, can this issue be dealt with by giving the federal insurance agencies the authority to require a prudent level of capital to support that activity in order to maintain insurance - rather than giving any federal agency the authority to override a state legislature? In other words, wouldn't the adoption of risk-based capital standards go a long way toward solving this problem?

Yes. The adoption of capital requirements that differentiate between the riskiness of banks' activities would go a long way in addressing whatever problems may arise as states expand the powers of state chartered banks. Risk-based capital standards would require bank managers to recognize the risk of those activities and satisfy themselves -- and ultimately their stockholders -- that the earning potential of the new activity justified its cost.

The maintenance of systemic safety and soundness involves a Federal interest that is broader than the protection of insured deposits. Thus, just as with current capital requirements, it would be reasonable for any such risk-based requirements to be coordinated by the three Federal bank supervisors, the OCC (for national banks), the Fed (for state-members), and the FDIC (for state-nonmembers).

If there is interest in providing the insurer with additional protection, Congress may wish to consider enhancing the insurance agencies' ability to terminate insurance for banks involved in imprudent activities.

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16. Mr. Isaac has stated that a significant number of bank failures are caused by fraud. Other than increased enforcement actions which are being taken by the federal agencies - aren't Mr. Homan (Former Senior Deputy Comptroller for Bank Supervision, Office of the Comptroller of the Currency) and Mr. Ryan (Former Director, Division of Banking Supervision and Regulation, Federal Reserve System) right as to the importance of the ON-SITE exam to ascertain the integrity of the numbers being generated and the lack of fraud? If so, does the decrease in on-site examinations bring with it an increase in the risk of fraud? If so, how can this be corrected?

Although fraud may have been perpetrated in a large number of banks that failed, very few bank failures can be attributed solely to fraud. Nonetheless, the potential for fraud in all banks is of great concern to this agency. The importance of on-site examinations cannot be denied, and they do in fact serve a very necessary purpose. However, we do not think they are the only means of obtaining information necessary to identify fraud.

On-site examinations are necessary to perform transactional reviews, but can only ascertain fraud after the fact. Of equal or greater importance are deterrents designed to prevent fraud. These do not depend on an on-site presence. We monitor the potential for fraud through the following means:

- Off-site analysis assists examiners in detecting signs of fraudulent activity. For example, increased loan volume or increases in a particular category of loans, increased

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fee income, sharp variances in past-due or non-accrual loan totals, and high or rising insider loans, may be indicators of fraudulent activity. Also, the lack of internal controls, management information systems, and audit procedures are indicators of banks that have a greater-than-normal potential for fraud. Armed with this information, examiners are better prepared to target areas for validation during an on-site review.

- One of the principal targets of our enforcement efforts is the integrity of financial reporting. We have brought many significant actions against major financial institutions because of misleading or inaccurate financial statements. We have publicized these actions in order to convey to all of the banking industry our commitment to enforcing the integrity of reported data. In addition, we support statutory changes that will authorize us to impose civil money penalties against individuals who file false information or false or misleading Call Reports with this Office.

- We are a strong proponent of banks' use of independent audits. Audits of banks are a strong deterrent to fraud and a tool that can be used by management to prevent

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fraudulent activity. As we discussed in Question 6, we have been encouraging, and in some cases requiring, increased use of audits by national banks.

- We have developed a close working relationship with the law enforcement community, including law enforcement authorities throughout the United States. This has resulted in cooperative efforts in the enforcement area, including receiving important information regarding potential fraud in specific institutions.

Our efforts in identifying fraudulent activity in national banks have not suffered as our on-site presence has lessened. On the contrary, we have developed more efficient means to monitor institutions that allow us to balance enforcement efforts with other priorities, including the many new and emerging risks to the system.

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17. Even though the FDIC continues to grow, how can or should we determine if the size of an insurance fund is sufficient and will continue to be sufficient?

There is no foolproof method to determine the adequacy of the insurance fund. Clearly, if the fund were experiencing severe declines, or sharply increased claims on the fund were expected, there would be justifiable concern as to the fund's adequacy. However, neither trend is evident.

The best way to ensure the continued adequacy of the fund is to minimize claims against it by ensuring that banks take appropriate safeguards against the risks that they undertake, and to close banks as near to economic insolvency as possible. Measures we have discussed elsewhere, such as risk-based capital requirements and increased flexibility in handling problem banks, could significantly reduce losses to the FDIC.

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18. In your opinion, what are the advantages and the disadvantages of risk-based capital and risk-based premiums? Should we consider one or the other or both? Why?

Risk-based capital requirements are preferable to risk-based deposit insurance premiums for several reasons.

First, risk-based capital requirements are preferable because they would subject banks to investors' scrutiny. Banks that chose to engage in riskier activities would have to find investors who shared their willingness to assume risks. Conversely, with risk-based deposit insurance premiums, a bank might pay a relatively high insurance premium, but, by relying on fully insured deposits, escape any judgment by investors.

A second advantage of risk-based capital requirements is that they would directly reduce the probability of failure. Banks that engage in more risky activities would have to maintain a greater cushion against losses.

Third, as proposed by the FDIC, risk-based insurance premiums would be assessed only after an institution had suffered the adverse consequences of the risks it had assumed. (To be assessed the higher premium an institution would have to have a CAMEL rating of 3, 4, or 5 and be classified as high risk by a statistical model that relies

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primarily on Call Report indicators of asset quality.) In contrast, risk-based capital requirements would impose an immediate up-front cost on institutions that choose to engage in risky activities and, we believe, serve as a more direct deterrent to excessive assumptions of risk.

This is not to say that there is no role for risk-based deposit insurance premiums. It may be advisable to adopt both risk-based capital requirements and risk-based insurance premiums. If, however, risk-based capital standards are applied appropriately, all banks will be capable of sustaining losses commensurate with the riskiness of their activities, and the threat of failure will be similar across banks. This will lessen the need for deposit insurance premiums that differentiate on the basis of risk.

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The CHAIRMAN. Next, we have two panels listed. We have run so long I would like to combine them and ask Mr. Cates and Mr. Keefe, Mr. Homan, Mr. Ryan, and Mr. Brooks to participate as one.

Gentlemen, we appreciate your willingness to testify today and it is taking much longer to get to this point than I anticipated, and so I repeat what I said in my opening remarks. Your entire statements will be placed in the record, and we would appreciate it if you could summarize your testimony. And I also did not anticipate the complexity of this subject. We will be asking a lot of additional questions in writing.

Mr. Cates, would you like to begin, please?

STATEMENT OF DAVID C. CATES, PRESIDENT, CATES CONSULTING ANALYSTS, INC., NEW YORK, NY

Mr. CATES. Thank you, Senator. The most general thing we can say about the discussion today is the necessity of assessing risk in banks. I find that the risk in banking is generally increasing and, at the same time, I find that the sources of disciplining that risk are also increasing. I find three sources of risk control in banking and it is important to look at each.

One, of course, is Government regulation; another is the discipline exerted by uninsured fund providers upon the policies of management; and the third—and I think the most important source of discipline in banking today—is the self-discipline or managerial discipline exerted by the industry itself.

RISK ASSESSMENT STRENGTHENED

And I think all three of these are strengthening. The regulators are strengthening their work, as we heard this morning, and so is the market, and so is the industry. To do this, it is necessary for all parties to assess the risk profile of particular banks. This skill underlies the discipline of bank risk control, whether by regulators, or by the market, or by the industry.

I think the highest and most noble definition of risk assessment in banking is that it's a lot like checking out used cars, where management is the salesman. You have to know what systems can go wrong, whether it's the drive train or the front end or the suspension. No matter how many tests you run there's a lot more you can't see.

It's no different looking at banks. We work with the concept of 7 banking risks in banking and we work with about 70 ratios and about 40 peer groups. What we look for are deteriorating numbers and funny numbers that don't add up to a strong picture.

There have been several sources of bank analysis. The regulators have developed their own tradition of analysis. Accountants have a tradition of analysis and the marketplace has developed, over the last 10 years, a very powerful system of analyzing banks. This analytic power creates the opportunity for a "second opinion" from the private sector to test the regulator's ability to anticipate the failure or crisis of banks. I was very happy this morning to hear the FDIC and the OCC disclose an updated report on the ability of CAMEL to anticipate the failure of banks.

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Our own system is pretty good by comparison. Looking at the 75 failures of 1984, for which we have data, we classified 90 percent into our 5 (or weakest) category, working from 1983 financial data, and we put 59 percent of the banks that later failed into our weakest category, working from 1982 data. The regulation still doesn't do that well even with onsite examination supporting them.

May I turn to some specific concerns of interest to your committee: risk-based insurance premiums. I think it's a great idea! Just like a smoker should pay higher life insurance premiums and teenage drivers should pay higher auto insurance premiums than I pay.

But I worry about the implementation by the FDIC. The implementation is risky and untested and the public knowledge of those insurance categories is dangerous. The FDIC ratio model, disclosed in the April 1984 report to Congress, is just too simple, it will not withstand professional scrutiny. I think the model should be tested against CAMEL ratings, it should be tested against the excellent private rating systems that are in place. All this should happen before anyone permits it to go public.

I'm particularly worried about the public knowledge of those insurance ratings. This is information that will leak, and it's very simple information, much more simple than a CAMEL rating. You will be either an "average risk" or an "above average risk," and I think that will become a lazy substitute for careful analysis by larger depositors.

I think it will stigmatize banks that are in fact not risky, they just happen to violate the standards of the FDIC insurance rating model. If we were to create a public health analogy, it's the same as hanging bells around the necks of lepers! Also, if the system is to work entirely "by the numbers," I'm worried. Where is the opportunity for judgment in critical cases? What do we do with the fact of Midland Bank ownership of Crocker? What do we do with the fact of FDIC ownership of Continental, in these insurance risk ratings?

A second item of concern that arose this morning is the notion of a 9-percent capital. I think that the cost of raising debenture capital by well-run aggressive community banks is going to be an unfair cost compared to the money center banks and large regional banks that have much broader access to investment banker issuance.

I also would like to see greater discussion of what are the indenture terms that are going to be built into the subordinated debt that the FDIC proposes. If the indenture terms allow the FDIC to wipe out the debt in a failure which they were not able to do in Continental, that loss of investor protection just makes it more difficult for banks to sell that sort of debt.

A third topic—risk-based capital. I think it's a good idea, because of the reasons that Mr. Selby mentioned. Risk is what capital is all about. And the total assets of a bank are not an adequate proxy for risk. But having said this, I am worried about two things: How is the regulatory apparatus going to quantify the risk off the balance sheet, and even on the balance sheet? That could become a nightmare of numbers. It's not just the type of business that banks conduct it's the way they conduct that business that determines risk.

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I also found in the regulatory discussion this morning an overemphasis on capital. My belief, based on the studies that our firm has done, tend to confirm the notion that banks fail because of mismanagement of liquidity, lending, and controls. They do not fail because of deficiencies of capital. It is much more important for you to focus on risk management than on higher capital. The latter will not save banks, it is merely watchful of a scarce resource.

DEPOSIT INSURANCE REFORM

I will now comment briefly on deposit insurance reform. I think that the problem in deposit brokerage is a very narrow one, and could be eliminated with a single reform, namely, to limit institutional coverage. That is, limit the deposit insurance coverage of institutions to $100,000 per institution.

This would have the effect of placing at risk those credit unions, savings and loans, public bodies and smaller corporations that like to spread fully insured deposits among any number of high rate banks. This happens whether they use brokers or not.

I don't believe that private insurance is an option for the time being, because the private insurance industry is already in shock over the losses from directors and officers policies and other bank insurance. Where they're going to get the talent and capital to substitute private insurance for universal deposit insurance by the FDIC and FSLIC, I don't know.

One of the most interesting things to come along in bank regulation is the self-disciplining of the banking industry by the industry itself. On May 17, the Federal Reserve Board issued a policy statement in which it mandates self-regulation of the risks inherent in large-dollar funds transfer networks.

Any bank that is going to incur an overdraft on Fedwire—the Fed's own payments network—after next March must evaluate itself. It must evaluate its credit controls, its operational controls, and, most interestingly, its general and overall credit worthiness. This review must occur, furthermore, at the board level, with directors discussing and approving that bank's self-evaluation of its creditworthiness. This process will surely intensify director liability. I find this truly an exciting experiment, deserving much attention.

One final point which I would like to make is that the regulators' key statistical system of ratio and comparative analysis—the Uniform Bank Performance Report—is actually in my opinion a rather weak tool of bank analysis. A lot of private analysts have gone well beyond the limitations of this Government report.

Thank you.

The CHAIRMAN. Thank you, Mr. Cates.

[The complete prepared statement follows:]

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STATEMENT OF DAVID C. CATES
BEFORE THE BANKING COMMITTEE,
UNITED STATES SENATE,
WASHINGTON, D.C. - JULY 23, 1985

I wish to thank the members of the Senate Banking Committee and its Chairman, Senator Garn, for the opportunity to testify here this morning.

Four broad topics, as I understand it, engage your attention in these hearings. I will re-interpret them as follows:

1. How well do Federal bank regulators (Federal Reserve, Comptroller and FDIC) assess risk in banking? Is it possible to improve these results significantly?

2. How should the discrimination of risk in banks best be built into the regulatory process? Risk-related deposit insurance? A risk-based theory of bank capital adequacy? Greater emphasis on market discipline? An emphasis on managerial self-discipline? A different set of standards for different kinds of banks?

3. When should banks be deemed in a crisis situation bordering on failure?

4. How should these failures be handled?

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In the brief time available to me, I will focus on the first two questions, comment on the third, and barely mention the last. This relative emphasis does not reflect my sense of the importance of the issues, but rather reflects where my professional competence lies.

I. The Assessment of Risk in Banking. One basic question is whether the relative and absolute riskiness of banks can be discerned at all. A second question has to do with the techniques for doing so. A third question asks, "What is risk?"

A. Can it be discerned? Until a few years ago the only bodies capable of answering this question were the regulators themselves. There was no "second opinion" from either the banking industry or from private analysts that could reliably test the regulator's skills in risk-assessment.

What tests are available? I submit that the only hard test of risk-assessment skill is the ability to classify those banks as "highest risk" that later fail. I will broaden the scope of this test to include those larger banks in crisis for whom failure has been deemed a difficult if not impossible policy option.

Any other test is too soft! Whether I or another professional analyst or regulator disagree on the risk classifications of viable banks is a matter of professional opinion. What counts

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is our ability to anticipate bank failure as well as the crises of larger banks that may not lead to "failure" in the technical sense.

Only once has a regulator disclosed its ability to anticipate bank failure. In a November 1983 article published by the Atlanta Federal Reserve Bank, a team of FDIC economists tabulated the pre-failure CAMEL ratings of those banks that failed in the years 1981 through mid-1983. As you know, CAMEL ratings are generated by bank examiners at the conclusion of each exam, and constitute the government's chief quantitative summary of the risk profile of all banks. Ratings of "4" and "5" are very poor. The so-called "problem list" of banks is comprised largely (if not entirely) of 4-rated and 5-rated banks. Admittedly, the fraction of all banks so rated (about 1,100 at present) is less than 8% of all 15,000 banks.

The research study showed that only 37% of the banks that later failed in 1981-83 were rated "4" or "5" in the year prior to their failures. Only 22% were rated "4" or "5" in the next to last year before failure. This record is not very reassuring. Not only does it call into question the regulatory ability to anticipate failure, but it appears also to undermine the validity of the "problem list", the size of that list, its trend, and the specific makeup of the list.

Perhaps, as the Comptroller has recently suggested, this

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particular FDIC research is not representative of the overall regulatory record. To verify this, all three regulators should disclose and discuss their CAMEL ratings as indicators of approaching failure and failure-like crisis. Perhaps, too, the governmental methods of bank risk assessment are as good as possible, and that failure -- and crisis -- are essentially unpredictable. How are we to know? I sumbit that only the "second opinion" of private analysts can answer this question.

To further this exploration, our firm, in effect, challenges the regulators to a duel in analytic technique with this Committee and the public as the beneficiaries of the outcome. Our grounds for throwing down the gauntlet are that we too operate a bank risk rating system that parallels the CAMEL system, except that our method (unlike CAMEL) is based entirely on quantitative, remote financial analysis of bank -- and bank holding company -- ratios.

Here's how we classified the 75 failures of 1984 for which we had 1983 financial data (there were 79 failures in total): 92% of these failures fell into our "5" category prior to their failure, 4% each into our "4" and "3" categories, and none into our highest ratings. Our ratings of these 75 failures based on their 1982 financials is less good: 59% and 12%, respectively, were "5" and "4", 24% were "3", and the balance (5%) could not be rated due to insufficient data. We still surpass by a wide margin the CAMEL record.

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To take some specific recent examples, our model classified as "5" (highest risk) the following larger failures of recent years, and did so for at least two years prior to each failure: Golden Pacific National Bank (failed June, 1985), Capistrano National (April, 1985), Continental Bank (May, 1984, though not technically a "failure"), Heritage Bank (March, 1984), Midland National Bank (October, 1983), Abilene National (August, 1982), Penn Square National (July, 1982), and Metropolitan Bank of Tampa (February, 1982). These ratings were derived from financial statement analysis alone.

Why do we do this?. Are we just ghouls prowling in the morgue of dead banks? We are committed to failure analysis because our business consists largely of assessing the soundness of banks. We have to prove -- to ourselves and to others -- that our methods are right. The only clear, clean test of the adequacy of an analytic system, as I have already said, is whether you can predict the failure and/or the publicized crises of banks. Analyzing failures, in other words, helps us define what a healthy bank is. If we know what brings them down, we are better able to judge what keeps them going.

Another benefit arising from failure analysis is that it forces us to articulate a theory of risk in banking. By studying the factors that seem to lead to failure/crisis, we can create a meaningful set of industry risk categories. This work tells us that there are several kinds of risk in banking today. We call

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this industry profile the "The Seven Deadly Risks of Banking".

B. How can bank risk be discerned? Risk exists whether we can measure it or not. The skill in bank risk analysis consists of finding ratios and interpretive schemes which can reliably summarize the risk profile of each bank. Our system for doing so uses over 70 ratios and 40 peer groups. The system involves dozens of complex interrelations among these ratios and peers. In our opinion, this is the bare minimum apparatus for analyzing bank risk. The historic origin of our system of risk analysis dates back to 1973-74 when we were consultants to Standard and Poor's Corp. in the design of a ratio analytic method for evaluating the credit of bank holding companies. We took another forward step when the FDIC commissioned our firm to develop and teach a course in bank financial analysis for its Examiner Training Program.

Permit me to illustrate our method -- and show you how easy failure prediction is -- by looking with you at an actual failure from this past April, the Capistrano National Bank of San Juan Capistrano, California. (Its total assets at December 31, 1983 were $70 million.) Let's begin with a ratio called "Large Liabilities to Earning Assets" (see Appendix A. line 5.15). This ratio asks the question, what percentage of earning assets are supported by more or less uninsured funding (large-dollar deposits and short term borrowings). For most banks those ratios are declining since 1981 because of improved

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access to consumer funding sources. For the peer group of banks whose assets fall between $40 to $100 million the normal or typical ratio is 10% of earning assets funded by large-dollar liabilities. The regional norm for the Far West banks in this size category is almost 20%, because California community banks tend to be jumbo-funded. Capistrano at the end of 1982 had a ratio of 40%, so its funding risk was of a high order.

If its asset quality was fine we would be less concerned about funding risk, so let's look at the asset quality signals. The net charge-off record in Capistrano (line 3.1) is not particularly an early indicator of failure, nor is it often an indicator of coming failure. One of the things we like to look at, therefore, to get a truer picture of asset quality, is the rate of growth in non-consumer lending (line 5.4). We have singled that out as a factor that correlates closely with failures, usually two or three years in advance of failure. Here we have a beauty! In 1981 (a year in which you did not want to be an aggressive lender), the bank had a 62% loan growth, preceded by 55% loan growth in 1980! When that is coupled with loan yields of 20% in 1981 and 18% in 1980 (line 1.5), the red flags are waving. This bank also had an 80% loans-to-assets ratio (line 5.12) which compares with a peer group norm of 70%. They were betting the bank on their skill as lenders.

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When we turn to the Capistrano holding company, formed in 1982, we see additional signs of financial disorder and unsupportable leverage. To illustrate, the holding company borrowed in 1982 (line 9.9), downstreaming the proceeds to the bank as "equity" (compare 9.10 and 8.14). This phenomenon is called "double leverage" (line 7.3). Another danger sign was the deficit cash flow in the holding company parent, measured by a ratio we call "cash flow match" (line 7.2). Reading all these "tea leaves", there could be little doubt in 1981 or 1982 that this bank would face some kind of crisis. The point is that the crisis was taking shape some years before the bank failed in 1985, and that these signs were clearly identifiable to an astute risk analyst.

C. What is banking risk? I refer the Committee to Appendix B, an article of mine published last November in the American Banker. A key point of this article is that there are multiple risks in banking, and that the concept of "risk profile" has now become timely, if not overdue. I have identified seven risks of banking, a more complex and useful anatomy than is implied by the oversimplified CAMEL approach.

A theory of risk, of course, has to underlie any risk assessment method, just as a theory of pathology has to underlie medical diagnostics.

II. The Control of Risk. It is easy to think of governmental

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regulation as a key bulwark in bank risk control. I disagree profoundly with this view, though I respect that regulation is the emphasis of your Committee's current hearings. I prefer to think that there are three parties to the disciplining of risk in banking. Least important is the governmental regulatory process, despite its great power and selective effectiveness. Increasingly important is the discipline exerted upon banks by uninsured funds-providers, a complex market of domestic banks (small and large), foreign banks, large and small corporations, municipalities, trust departments, money market funds, pension funds, and so forth.

Most important of all is the managerial self-discipline of banking risk. The proof of the vitality of this front-line discipline, in my opinion, is that last year only 6/10ths of 1% of banks betrayed their trust to the point of failure. This year the number of failures may reach 100, a little over 7/10ths of 1% of all commercial banks. Banks on the "problem list", furthermore, are far from being terminal cases, and the overwhelming majority return to health.

To illustrate the power of managerial self-discipline as a risk control resource, I refer you to a recent (May 17, 1985) policy statement of the Federal Reserve Board of Governors which mandates, among other things, that the directors of some 2,000 larger banks self-evaluate the general and overall soundness of their banks, and attest to this soundness as a condition of

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using the Federal Reserve payments network, called Fedwire.

This total framework of risk control in banking -- by regulators, by large funds-providers, and by managements -- provides a context within which we can evaluate some of the governmental regulatory steps that might be taken.

A. Risk-adjusted deposit insurance. I am deeply opposed to risk-related premiums, for three reasons. First, I don't believe that the FDIC has demonstrated a risk-assessment methodology that would be reasonably fair. Certainly the FDIC CAMEL ratings do not inspire confidence. In its April 1984 report to Congress on deposit insurance, moreover, the FDIC proposed an overly simple set of ratio tests that simply cannot stand up to professional scrutiny by others who also evaluate banking risk. If the FDIC were to opt for a more reliable technique of risk assessment, it would, I think, be too complex to explain and defend in any review procedure or adversary proceeding.

Second, even if the risk ratings were reliable, the Federal designation of "above average risk" (or its equivalent) could not possibly remain confidential. The leakage of this simple and important information would stigmatize banks in the eyes of the public. Worse yet, it would become a lazy substitute for careful financial anaysis by funds-providers. If we were to seek an analogy in public health administration, risk-related

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insurance is like hanging bells around the necks of lepers except that half the affected banks would merely have bad cases of acne.

Third, this clumsy and drastic step is not necessary. Other regulatory policies are sufficient to control banking risk and managements and funds-providers are helping, not hurting, this control process.

B. Risk-related capital. Bank capital adequacy, a perennial subject of debate, is about to undergo a revolution. On one side of the argument is the FDIC and Treasury, proposing that bank capital should be 9% of assets, with one-third of that consisting of subordinated debentures. These debentures, it is argued, will force "market discipline" on banks, since their holders are uninsured. A very different point of view is emerging within the OCC and FRB. This says that the very notion of "capital" to "assets" is in error, since it fails to capture the risk component of banking which capital is supposed to underwrite. Specifically, the current formula encourages banks to shove risk off the balance sheet, in the form of letters of credit, interest-rate swap brokerage, etc. It also discourages banks from storing liquidity on their balance sheets, since they are penalized for doing so by too high a cost of capital. To put it another way, OCC and FRB thinking wants to "unbundle" the concept of bank capital adequacy and relate capital to risk (however measured) rather than merely to

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assets, a poor proxy of risk.

A market-based analyst like me tends to think of the present regulatory policy toward capital as so much green cheese on the moon, totally lacking any theoretical justification. Therefore I oppose the FDIC proposal as a silly waste of market capital and an unnecessary burden on good, aggressive community banks for whom the issuance of debentures would be costly. If capital is to be strengthened in banking, let it be measured against risk, not assets.

The market-based analyst has a problem with the quantification of capital adequacy that might emerge under a risk-related capital policy. The regulators are talking about a fixed system of capital to various types of risk: 3% of Treasuries must be capitalized, 8% of loans, etc. Though I appreciate the need to seem "fair" to all 15,000 banks, and the equal need to give precise guidance to thousands of highly confused field examiners of banks, this quantitative plan is doomed to replace one form of madness with another. The problem is that risk in banking is not according to classes of business, but according to the policies, skills and safeguards which guide the conduct of business. Ultimately, therefore, the determination of risk depends as much upon management as it does upon gross volumes of this or that financial product. At bottom, it is a question of judgment.

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Finally, I can understand why it is good to modernize the concept of capital adequacy, but I can't understand why more capital needs to be forced into banks. Over 60 years of banking history should tell us that bank failure is not prevented by strong capital, nor is low capital a precursor of failure. Bank capital ratios in the 1920s and 1930s were three to four times as high as they are today, yet thousands of banks failed every year.

What causes banks to fail, our careful study documents, is mismanagement of liquidity, lending, and operations. Capital is essentially irrevelant to this set of causes. For regulators, Congress, and the public to insist on stronger capital is to miss the point. The point is to keep the riskiness of banking under scrutiny, under reasonable control, and reasonably capitalized.

C. Other Regulatory Steps. The modest steps I believe are desirable would be even more important to undertake if the banking situation were less stable than it is. This comment needs some support. As I see it, the banking industry is in fact highly stable despite disinflation, deregulation, Latin debt, and other challenges. The failure rate is extremely low, the liquidity of banks is improving because of new access to consumer funding sources, market discipline by uninsured funds-providers is becoming more rational and more effective, and industry self-discipline, as I have argued, is on the

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rise. There's simply no crisis in banking deserving grand remedies. There are pockets of problems deserving specific, appropriate remedies.

A. Better surveillance. Regulators should disclose the facts of their ability to anticipate failure or crisis. The spotty evidence so far does not suggest they discharge this important task well. If so, they need to strengthen their anticipatory skills. Since private analyst skills are in fact strong, there exists today a resource against which to measure the effectiveness of regulatory risk-assessment.

One example of the weakness of regulatory analysis is the so-called Uniform Bank Performance Report. Its defects make it a poor tool of comparative analysis and crisis anticipation. For one thing, it is unnecessarily lengthy and cumbersome. For another, it does not adequately measure and compare year-to-year changes in condition and performance. Third, its peer group references are insensitive to important differences among banks according to size and location. Fourth, it fails to integrate holding company analysis with bank analysis. Finally, it is quite blind to off-balance-sheet risk. These problems have all been solved by private analysts.

B. Deposit insurance. One abuse of the deposit insurance system occurs when institutions -- credit unions, other thrifts, corporations and local government -- "spread" a total

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deposit of, say, $1 million across a number of insured depositories in amounts of $100,000 each. Sometimes they use a broker to affect these deposits, sometimes not. I propose that institutional depositors be insured only to $100,000 per institution. This should force them to be more careful about their depositing, and to accept a risk penalty when they seek high deposit yields.

An idea worth discussion is to introduce a "modified payout" plan which would start at, say, 99% of uninsured funding (including Fed funds). This would affect any bank deemed to be a failure, whether it is liquidated, merged, or "assisted". After perhaps two years, the payouts would drop to 98%, then to 97%, and so forth. This graduated plan would provide at first only a slight penalty for unwise depositing, not enough to cause a mass flight of funds to "safety".

As for private insurance, I doubt whether the insurance and re-insurance industries are ready to offer a privatized version of universal deposit insurance. A look at the bank insurance market today -- particularly directors' and officers' liability coverage -- does not augur well for the huge investment of talent and capital that would be required.

III. <u>When Should Banks Be Deemed Failures</u>? My view is that banks should not be prevented from failing, as long as the process for dealing with the consequences of failure are

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orderly. Bank failure today discourages failure tomorrow, because it dramatically warns managers, funds-providers, and investors what strategic and managerial pitfalls to avoid. With the rate of failure today running at roughly one-fifth the rate of new bank charters, there should be no concern that failures are out of balance.

As for the very largest banks, their occasional crises should be managed quietly, skillfully, and on an ad hoc basis, rather than out of some rulebook written at the FDIC.

IV. The Thrift Industry. My comments so far have been directed at the regulation of commercial banking, a system I consider quite sound. Savings banks and FSLIC-insured thrift institutions present a much more severe situation. To put it in perspective, commercial banks generally enjoy access to unsecured credit from other banks, securities dealers, and other professionals. This is true of only a small fraction of thrifts. Their credit at commercial banks is quite limited, and -- to take a telling example -- their standby letters of credit are largely secured by mortgages in order to satisfy third parties.

The two problems facing thrifts, of course, are interest-rate risk and asset quality risk, the latter arising from rapid growth following the deregulation of asset powers in 1980. Underlying these visible and universally acknowledged risks are

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two deeper concerns: strategy and management. What kind (or kinds) of industry does it want to be as it seeks its place within a highly competitive and largely deregulated financial services marketplace? Where is the management to come from if these risks are to be controlled? Finally, is the FHLB system a tough enough and skillful enough regulator to see its industry through the present crisis? I have little confidence in any answers I have heard to these questions. By contrast, the commercial banking industry is sound as a nut.

Thank you again for the opportunity to testify before this Committee.

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CATES BANCOMPARE © II DATA/RATIC REPORT

CAPISTRANO NAT BANK
SN JUN CPSTRN CA 06-1534
4800

PEER GROUPS
:BANK 40 - 100 MILLION
:BHC

3691/ 202

		Nation by Size Peer Group 1984	Region by Size Peer Group 1984	1984	1983	1982	1981	1980 1984/80
1.0	EARNINGS BANK							
1.1	Return on Assets	1.03%	0.76%	-5.09%	-1.90%	-2.96%	0.62%	1.04%
1.2	Return on Equity	12.60	9.62	-128.81	-59.27	-55.71	8.31	13.65
1.3	Net Income % Change	4.31	12.41	-172.92	32.48	***	-7.25	
1.4	Earning Asset Yield	12.60	13.81	15.13	15.39	16.57	18.43	16.00
1.5	Loan Yield	13.36	14.52	15.95	15.32	16.89	20.06	17.70
1.6	Break Even Yield	7.50	7.20	7.32	7.13	8.66	9.09	6.80
1.7	Effective Interest Exp Rate	9.10	9.10	8.92	8.13	10.80	12.99	10.89
1.8	Net Interest Margin	5.13	6.55	7.60	8.25	7.91	9.33	9.20
1.9	Overhead to Adj Oper Inc	56.59	73.39	102.84	99.86	123.24	85.16	73.81
1.10	Personnel Expense to AOI	28.57	37.46	46.05	39.56	47.91	41.71	35.18
1.11	Overhead % Change	8.03	14.25	***	-2.44	57.61	82.49	
1.12	Net Overhead to EA	2.54	4.47	8.06	8.24	10.13	7.78	6.52
1.13	Non-Interest Income to AOI	11.59	14.37	20.66	28.10	17.16	10.83	10.14
1.14	Loss Provision to AOI	5.45	6.80	60.84	21.12	18.29	4.57	3.47
1.15	Tax-Exempt Inc to Pretax NI	55.80	25.21	***	***	***	33.98	6.45
1.16	Marginal Tax Rate	45.36	41.48	0.00	3407.00	0.00	31.45	47.25
1.17	Sec Gains/Losses inet to NI	0.00	0.00	0.00	-0.16	-0.16	0.00	0.00
2.0	LIQUIDITY BANK							
2.1	Earning Assets to Assets	91.46%	87.77%	80.75%	76.97%	80.69%	83.84%	84.56%
2.2	Large Liability Dependence	-9.40	5.90	23.10	25.84	36.49	29.68	12.41
2.3	Invest Secs 5 Yrs to EA	4.70	1.91	0.15	0.58	0.93	1.22	1.18
2.4	Core Deposit % Change	9.17	18.89	-0.51	30.78	29.76	37.55	24.40
3.0	ASSET QUALITY BANK							
3.1	Net Charge Offs to Loans	0.40%	0.40%	3.59%	2.44%	1.68%	0.53%	0.26%
3.2	Recovs to Gross Charge Offs	17.32	11.31	7.88	5.89	4.54	13.17	0.00
3.3	Earnings Cov of Loan Losses	7.34x	5.88x	*** x	*** x	*** x	3.20x	13.58x
3.4	Loan Mix % Retail	43.12%	38.43%	30.41%	32.96%	34.26%	30.04%	27.52%
3.5	OREO to Loans + OREO	0.27	0.56	7.90	4.75	2.89	1.68	1.22
3.6	Non Perform Loans to Loans	1.80	2.35	14.80	8.04	***	***	***
3.7	Loss Allowance to Loans	1.00	0.96	6.14	2.06	0.96	0.58	0.80
3.8	Loss Provision to NCOs	120.83	140.64	188.56	114.32	126.85	116.85	188.68
4.0	CAPITAL BANK							
4.1	Equity to Total Assets	7.93%	7.52%	3.95%	3.21%	5.31%	7.43%	7.61%
4.2	Primary Capital to Tot Assets	8.32	7.74	4.83	2.82	4.71	6.60	9.04
4.3	Total Capital to Total Assets	8.38	7.77	5.26	3.25	4.71	6.60	9.04
4.4	Term Debt to Tot Capn	0.00	0.00	0.00	0.00	9.56	7.19	0.00
4.5	Cash Dividend Payout	28.57	0.00	***	***	***	0.94	0.58
4.6	Capital Formation Rate	8.59	8.30	-275.69	-46.81	-50.69	8.39	18.86
4.7	Asset % Change	8.80	16.01	1.92	4.98	24.04	56.11	21.76
5.0	BALANCE SHEET BANK							
	% Change							
5.1	Temporary Investments	21.67%	19.76%	12.73%	-40.29%	-25.12%	16.82%	-6.97%
5.2	Investment Securities	8.17	10.71	-26.44	-20.80	21.09	34.02	1.97
5.3	Loans	12.70	23.98	4.71	7.15	30.33	66.54	27.18
5.4	Non Retail Loans	13.48	25.14	6.73	9.51	24.02	61.84	25.53
5.5	Demand Deposits	-0.17	8.52	-3.56	4.82	10.14	31.31	10.68
5.6	Other Core Deposits	11.84	23.79	1.48	55.91	56.80	47.18	40.34
5.7	Large Liabilities	7.09	14.40	-2.74	-29.31	23.23	97.04	22.06
	As % of Earning Assets							
5.8	Temporary Investments	18.03%	13.45%	7.05%	6.69%	11.22%	17.88%	23.69%
5.9	Taxable Investments	22.12	10.48	3.83	5.87	5.44	4.81	7.41
5.10	Tax-Exempt Investments	9.85	3.08	0.79	0.98	3.12	3.68	2.37
5.11	Loans	58.42	74.91	89.08	90.97	85.02	77.87	72.37
5.12	Demand Deposits	16.13	23.02	33.47	37.11	35.46	38.43	45.29
5.13	Other Core Deposits	71.46	58.07	54.09	57.00	36.61	27.87	29.31
5.14	Regulated Rate Deposits	16.94	14.38	15.98	19.56	***	***	***
5.15	Large Liabilities	10.32	18.78	27.95	30.72	43.52	42.16	33.12

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		Nation by Size Peer Group 1984	Region by Size Peer Group 1984	1984	1983	1982	1981	1980 1984/80
6.0	HOLDING COMPANY: CONSOLIDATED							
6.1	This Bank to: Consol Assets	%	%	%	%	%	%	%
6.2	:Consol Net Income							
6.3	All Bank(s) to: Consol Assets							
6.4	:Consol Net Income							
6.5	:Consol Net Chg Offs							
6.6	Non Bk(s) to: Consol Net Inc							
6.7	All Banks: Div Payout							
6.8	Consol BHC: Return on Assets							
6.9	:Net Charge Offs to Loans							
6.10	:Loss Allowance to Loans							
6.11	:Equity to Assets							
6.12	:Term Debt to Tot Cap'n							
6.13	:Cash Dividend Payout							
6.14	:Capital Formation Rate							
6.15	:Net Income % Change							
7.0	HOLDING COMPANY: PARENT ONLY			CAPISTRANO NAT BANK				
7.1	Fixed Charge Coverage	x	x	x	x	x	x	x
7.2	Cash Flow Match							
7.3	Double Leverage	%	%	%	%	%	%	%
7.4	Double Leverage Payback	YR	YR	YR	YR	YR	YR	YR
7.5	Liabilities to Net Worth	%	%	%	%	%	%	%
7.6	Term Debt to Tot Cap'n							
	As % of Parent Assets:							
7.7	Financial Assets	%	%	%	%	%	%	%
7.8	Loans and Advances: Bank							
7.9	:Non-Bank							
7.10	Equity Invests in: Bank Subs							
7.11	:Non-Bank Subs							
8.0	BANK DATA (000)	1984 less '83		1984	1983	1982	1981	1980
8.1	Average Total Assets	1296		68868	67572	64368	51891	33241
8.2	:Temporary Investments	443		3921	3478	5825	7779	6659
8.3	:Other Investment Securities	-687		677	1364	2234	2065	1321
8.4	:Total Loans	2227		49542	47315	44156	33880	20344
8.5	:1-4 Fam Mortgages	-1154		7325	8479	7252	4164	2020
8.6	:Core Deposits	-248		48700	48948	37429	28645	20971
8.7	:Large Liabilities	-438		15542	15980	22605	18344	9310
8.8	Year End: Total Assets	-11483		58224	69707	66929	60227	43842
8.9	:Fixed Assets	-422		2768	3190	3436	3296	741
8.10	:ORED	1181		3582	2401	1322	696	317
8.11	:Capital Debt	0		0	0	0	0	
8.12	:Mortgage Debt	0		0	0	290	291	0
8.13	:Loss Allowance	1563		2563	1000	426	236	206
8.14	:Equity	-664		636	1300	2745	3754	3777
8.15	Adjusted Operating Income	-501		5470	5971	4960	4553	2879
8.16	Loss Provision	2067		3328	1261	907	208	100
8.17	Overhead	-338		5625	5963	6112	3878	2125
8.18	Pretax Net Income (Book)	-2222		-3507	-1285	-2165	362	620
8.19	Sec Gains/Losses (net of tax)	-2		0	2	3	0	0
8.20	Net Income	-2222		-3507	-1285	-1903	320	345
8.21	Extraordinary Items	-77		-77	0	0	0	0
8.22	Dividends	0		0	0	0	3	2
9.0	HOLDING COMPANY DATA (000)	1984 less '83		1984	1983	1982	1981	1980
9.1	Consol BHC Total Assets							
9.2	:Net Income							
9.3	Parent Only: Total Assets							
9.4	:Financial Assets							
9.5	:Loans and Adv to Subs							
9.6	:Equity Invests in Subs							
9.7	:Goodwill							
9.8	:Short Term Debt							
9.9	:Long Term Debt							
9.10	:Net Worth							

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Comment

Disciplined Bank Management Can Turn Risk to Its Advantage

The following remarks were delivered earlier this year at a Bank Administration Institute-sponsored large bank problems and failures conference in Hanover, N.H.

By DAVID C. CATES

Some 20 years ago, bankers abhorred risk. At the same time, they knew nothing about managing risk other than to avoid it!

I well recall the views of William S. Gray, the former chairman of the Hanover Bank 1929-61, who often said, "Bankers never borrow, customers borrow." This negative epigram encapsulates an innocent and obsolete world-view that could never work today: banks as fortresses of soundness amidst an uncertain world, the banker a nay-sayer with no vision of the future, no stake in economic development.

Most contemporary banks, certainly all large banks, have now embraced risk as an inevitable concomitant to the strategies of their enterprises. They have gradually learned to do this over (roughly) two decades, in response to three driving forces:

• First, the people who run banks have an unavoidable responsibility to their shareholders, measured by their attainment of a competitive return on equity. To abdicate this responsibility is, in effect, to adopt a strategy of retrenchment.

• Second, bank policies are in part shaped by public policy: It cannot be denied that since 1961 successive administrations have strongly urged banks to support various domestic and foreign economic development goals.

• Third, there is a widespread excitement that comes to pervade any industry, like banking, that is modernizing and expanding on many facets. This enthusiasm, once established, becomes self-perpetuating, leading to further explorations of opportunity.

In most large banks, these three driving forces to accept risk are disciplined by what is commonly called good management. Still other banks are undermanaged, and a few — a very few — have been overwhelmed by the magnitude of risks they have knowingly or unwittingly assumed.

Map of Bank Risks

Isn't it about time, therefore, that we drew a map of the risks of banking? If risk mismanagement causes banks to fail, and if good management lets them prosper, we should want to analyze what are the risks of banking that all larger banks face? Excessive risk is what causes banks to fail. Let's try to agree, then, on what risk is.

This map should have four attributes:

• First, our catalog of risks should not be so truncated as to blur important differences among types of risk, nor should it be so lengthy as to lose the attention, say, of a board of directors.

• Second, the categories of risk should be immediately understandable to the common sense of senior bankers: If we cannot engage their attention we will accomplish nothing.

• Third, the categories of risk should reflect the analytic concerns of funds-providers and investors as well, so that risk analysis can be shared with outsiders.

• Finally, the headings that make up this list should be, wherever possible, amenable to quantitative, comparative analysis. In this way, risk appraisal can be tested against objective standards. The two key standards, of course, are the performance of peers and the performance criteria of market.

I call my contribution to this dialogue the Seven Deadly Risks of Banking. In the same breath let me reemphasize that risk is a constructive and inevitable companion to the business of banking and that managers of banks should equally think of these risks as challenges and opportunities.

Degrees of Severity

My list is ordered according to the speed with which each type of risk can destroy a banking institution. The first two, when sufficiently present together, will bring a market-funded bank down overnight. The next three risks work more slowly, rarely causing sudden failure. The final two determine whether a bank (or bank holding company) will survive under its own charter or be forced to merge in order to survive.

• Funding Risk. Can a bank readily renew its uninsured liabilities?

• Asset Quality Risk. Are its assets collectible at better than 99 cents on the dollar?

• Control Risk. Is the bank threatened by financial liability arising from operations other than outright lending?

• Interest Rate Risk. Will earnings be seriously diminished by deliberate or involuntary mismatching?

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• Overhead Risk. Are profits — and pricing flexibility — choked by excessive support costs?

• Strategy Risk. Has the bank chosen viable marketing goals, and does it possess the technology to see it through?

• Capital Risk. Can the bank occasionally find new capital — including acquisitions — on favorable (that is, nondilutive) terms?

Clearly, these risks, challenges, and opportunities are interrelated. Clearly, they are more complex than my oversimplified summaries. This anatomy, however, seems to make intuitive sense to bankers and analysts alike. It's framed in such a way to generate largely quantitative answers, and it lends itself, for the most part, to hard comparative analysis. Whether you accept this anatomy of banking risk, or some other, it is hard to imagine a useful discussion of the future of banking that does not address the kinds of risk to which the industry has become subject.

How to Forestall Crisis

What I want now to address is how we go about stabilizing the rate of bank failure in general, and in particular how we can forestall crisis among large banks. These goals may not be attainable, but they are approachable, the more so if all participants in the process understand one another and work together as a preventive coalition. To put the problem in perspective, let me point out that if there are 75 bank failures in 1984, this will be only one-half of 1% of the 15,000 banks now in existence!

As I see it, there are three — and only three — sources of discipline acting to constrain the risk-taking which, in the extreme, causes larger banks to fail: the regulator, the funds-provider/investor, and the manager — yes, the manager! Of the three, I will argue that the third, like it or not, is by far the most crucial, for which in fact there is no substitute.

In my opinion, it is vitally important that policy-makers have correct views about the true and emerging roles of these three disciplines. For example, it would be a dangerous misperception to belittle the adaptive power of bank managers, to deny the cautionary role that the market has begun to play, or to yearn for a stronger regulatory function. Carried to an extreme, such views will not only shackle an essential industry but — ironically — lift its level of risk to unsupportable heights.

I will also argue that regulatory discipline, though effective for small banks, is rather inept applied to large banks. Conversely, market discipline — the prudential role of uninsured funds providers and investors — is fast becoming valuable and significant for large banks, least valuable for small banks.

My definition of "regulators" is not confined to the mere supervisory function, central as this is. It also includes management of the deposit insurance function, governance of monetary policy, congressional oversight and, finally, Administration pressure on banks to support various domestic and foreign policy goals.

Whether taken as a whole, or piece by piece, this unpredictable and politicized apparatus hardly seems capable of regulating risk in banking without crippling the patient.

Senior regulatory officials privately confess the difficulties of staying abreast of the "leading edge" activities of major banks — interest rate swaps, daylight overdrafts, futures, and options, to name a few. The problem is not that key people in civil service fail to understand these fast-moving, high-tech frontiers. It is just that the average examiner team is unequipped to evaluate what large banks are up to. In my opinion, this explains why the risk-constraining record of regulators is so poor: they permit risk to accumulate past the point of no return, not so much because they lack enforcement powers, but because too often they don't know what to look for, or how to interpret what they find.

Computer surveillance of banks by federal regulators is not uniform. As a result, the remote tracking systems of the Office of the Comptroller of the Currency, Federal Reserve Board and Federal Deposit Insurance Corp. give conflicting signals of which banks are on whose "watch list." More important, regulatory surveillance models have not incorporated data flowing from the holding companies which control almost all larger banks. Thus bank regulators are unable to duplicate the credit/investment analysis performed by the market.

Without this ability, they can hardly be sensitive to the signals of the market. As I have insisted, it is the market, in the end, which brings large banks down. Regulators seem incapable of anticipating or understanding this key factor in large bank failure.

As if to acknowledge their incapacity to judge a bank's management of the multiplicity of risks, regulators have substituted for this crucial deficiency a preoccupation with capital. They argue, of course, that the requirement of a high level of capital slows the risk-taking entrepreneur and is, at the same time, "fair" to all banks. One of its effects, however, is to drive more risk-taking off the balance sheet into a shadow banking world immune so far from arbitrary capital rules.

A more serious effect is to force risk-taking on the part of banks reaching to achieve competitive returns on capital sufficient to keep attracting private investors. At some point, in other words, unrealistic capital standards become self defeating as a risk deterrent.

A shocking inequity has been developing between the federal regulation of thrifts on the one hand and banks and bank holding companies on the other. While the two industries are converging in the market place, the regulatory standards are diverging, particularly with respect to capital requirements.

There are modest enough steps that the regulatory machine can take to improve its effectiveness, steps like higher recruitment standards, state-of-the art professional training, realistic compensation, merit-based promotion, and more effective computer surveillance. Without such steps, grand plans to re-regulate the banking industry are sure to founder as soon as they are enacted, to say nothing of the damage these clumsy efforts will cause.

No Confidence in Rescues

In 1983, I was commissioned, among others, by the FDIC to research the need for deposit insurance reform and the shape this might take. In the course of my research I surveyed a number of megadepositors, such as large foreign

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banks, money funds, and giant corporations. I was surprised to discover that without exception they regarded the FDIC as lacking both statutory and financial capacity to rescue very large banks. These creditors, furthermore, prided themselves on their developing skills to avoid failure-prone institutions.

My studies also persuaded me that the credit analytic sophistication possessed by the largest funds providers (and their outside advisers) was rapidly trickling down to the middle market of uninsured creditors. This dissemination was occurring for three reasons.

First, bank/bank holding company financial disclosure is now comprehensive, frequent, and accessible. Second, analytic methods are now in place to interpret this data. Finally, analytic specialists such as Cates Consulting have developed reliable risk assessment products specific to this large and growing market.

This was the situation prior to May 1984 when the Fed, FDIC, Comptroller's Office, and Treasury issued public statements explicitly guaranteeing the liabilities of Continental [Illinois National Bank and Trust Co.] and other very large banks. Have these statements dissolved the concerns of uninsured creditors? One can hardly imagine a more important question affecting the future of large banks! If you believe the answer is "Yes," the bulwark of market discipline is removed. With it then disappears that healthy fear among bank managers that unsound policies will be recognized — and penalized — by uninsured funds providers.

Now for the facts. The truth is that market concerns over the creditworthiness of large banks has *not* dissolved. This relatively new bulwark against undue risk in banking appears to have a deep foundation in the perceptions of funds providers. If so, it will increasingly exert its guardian role. The implications for public policy are large, for it means that the uninsured funds provider now serves as a coregulator of the level risk in larger banks.

I have three reasons for asserting that market discipline is alive and well. The first piece of evidence is that our firm's growing sales of bank credit ratings and the analytic materials that support these ratings have continued unabated since last May. Our competitors report a similar phenomenon.

Client Questions Persist

The second piece of evidence is the reasoning of our clients about why they are not altogether tranquilized by the federal press releases announcing the government's protectorate of large banks. If any of you had, say, $5 million on deposit in a large bank, your boss would be asking these questions: What is the statutory or contractual basis of the guarantee? How many banks might it cover?

Does the FDIC have the financial capacity to make good immediately on the guarantee? Can we afford even a momentary disruption of first rate service from our bank? Can we afford any loss of interim marketability on our certificates of deposit? How do I (say I am an assistant treasurer) look to my board if a bank in crisis shows up on our list of depositories? The easy answer to these questions, of course, is to avoid such banks prior to crisis.

My third piece of evidence is that no professional market participant believes that bank holding company paper will be federally protected in a future crisis, despite the strange FDIC rescue of the Continental parent investors. Thus a highly visible window of discipline will continue to shine upon the commercial paper, term debt, preferred and common stock of bank holding companies.

Signals of investor distress emerging from any of these markets will be seen by the creditors of the affected banks. Indeed, the timing of the Continental crisis can be traced in large part to the poor behavior of the stock in 1984 and the growing disbelief of analysts that the common dividend was sustainable.

The ratio analytic techniques now in place to evaluate the credit investment worthiness of large banks are not random and meaningless exercises in tea-leaf reading. Since its modern origin some 10 years ago, bank and bank holding company credit analysis has proven to be rational, cogent, consistent, and predictive. By this, I mean that a good analytic system can distinguish those banks least able to withstand shock, from those most able. Market discipline need do no more than this.

Across the last 20 years, banking has lost its innocence. Indeed, many banks today are as entrepreneurially stretched as some of their borrowers! Worse yet, much of the public — both lay and professional — has come to believe that big banking is somewhat out of control and that the term "reckless" is not exactly misapplied to the industry. It does not matter whether you or I share that belief. What matters is that a widespread public impression has been created out of the real mismanagement of a few large banks.

What we are talking about, of course, is corporate governance. The issue is whether the managements of large banks have the will and capacity to control the levels of risk within their organizations. Can it be done at all? Are senior managers of banks so driven by ambition, competition, and sheer bigness, so shielded from reality by opportunistic subordinates and passive directors, that the concept of risk has altogether lost its self disciplinary bite? There probably is no question more important than this as we survey the future of large-scale banking. Your views on this question, therefore, will help to shape your public policy recommendations.

High Management Standards

The self evident performance and strength of the majority of big banks seems, in my opinion, to demonstrate sufficiently that these banks are not only strong and profitable but are governed by high standards of prudence at key management positions. A wide acquaintanceship among senior and junior bankers, furthermore, tells me that there is a deeply embedded culture of risk management in the banking professions, that this professional integrity is quite passionately maintained, and that usually overrides conflicting goals such as near-term earnings gains. For this to work, however, senior management must provide strong leadership.

Not every large bank, however, is run with such managerial excellence. Our next question must be: "What is the outlook for a return to prudence by that minority of banks that have strayed or are straying into unacceptable risk?"

Let me give you three reasons for believing that we are now witnessing a dramatic renewal of self-discipline in banking:

- Compared to other industries, bankers are very standards conscious, which is to say that they are peer sensitive. This is not merely an accident of culture. Once aroused, the industry is its own sternest critic, simply because it is so financially interdependent! The credit of one bank affects the credit of many others, however indirectly. When banking leaders establish a standard, the message to peer bankers is quite clear.

The shock wave of the Continental failure has told leader after leader that risk is indeed a four-letter word. Banks I know are renewing their awareness of risk, establishing top-level "exposure committees" which often transcend the loan-review and auditing functions, building loss reserves and recognizing loan losses earlier rather than later. Risk assessment is fast becoming a watchword in the industry.

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• The market of bank funds providers and holding company investors is also prompting bankers to rediscover that risk has teeth. If — as I expect — the discipline of the market does not dissolve in the wake of a few high-sounding federal press releases, the recent emergence of creditors as coregulators of banking will be a constant reminder to wayward managements.

I want to emphasize that this "chill factor" is a new element in bank risk control. In the wake of 1974-75 (a comparable prior episode of bank failure and funding nervousness), the just-crafted tools of modern bank credit analysis were still primitive and little-recognized. Today, the skeptical depositor/investor in large bank paper knows the right questions to ask and has the data to document these questions.

Compare this development in banking, by the way, to other financial services companies, notably thrifts, insurers, and securities brokers. Because of disclosure requirements, large banks and bank holding companies have become fishbowls for beady-eyed inspection by funds-providers. By contrast, that sort of market discipline is almost absent in the other financial industries. Since these other industries are also less regulated, the effect is to place large banks under double jeopardy: the market and the regulator, both loaded for bear. My point is not that this is unfair (though it is), but rather that large bank management now has two layers of unsympathetic kibitzers to deal with.

• Directors of larger banks may be collectively passive as a board but are usually man-eating tigers as individuals. This strange paradox carries with it some uncomfortable contradictions which occasionally cause a board to rise up and take charge of a crisis. My guess is that many bank boards will now begin to insist on more objective assessments as a basis for judging the performance of management.

As it is, their typical menu of monthly or quarterly financial reports is all internally generated. One way to insert objectivity into this process is to give a board, at least annually, a comparative presentation based on credit analytic principles. Since credit analysis is nothing more than risk analysis from a market perspective, the board gets to look not only at the company's risk profile but at the market perception of that profile as well.

To emphasize this point, consider whether the Continental board, in late 1982 or early 1983, might not have risen up, cut the dividend, reversed the suicidal growth strategy, and installed conservator, work out management. If this had occurred, it is unlikely, in my opinion, that the bank would have lost the confidence of its funds providers.

Risk Controls Needed

I will close my talk with four observations. First, risk management in banking has nothing to do either with governmental "deregulation" or "reregulation." If risk controls are in place — as they are for the majority of large banks — new ventures will be undertaken, as in the past, within that mantle of self-protection. If, conversely, risk is poorly managed, no amount of government regulation will protect the industry from itself.

Banks, by definition, are in a risk business. The objective is not to try to reduce these risks to zero, but to understand them, accept them, lose a bet occasionally, and — stay in control! A corollary point is that the occasional crisis must also be controlled.

This is because risk management in banking is an exceedingly intricate process that occurs simultaneously on many fronts, some of a credit nature, some of an operational nature. Were the intensified regulation to be as inept and bureaucratized as the old regulation, how could it possibly cope with the realities of bank risk? As I said earlier, banking — at least large banking — seems to have outgrown regulation.

My second observation is that banks, by definition, are in a risk business. The objective is not to try to reduce these risks to zero, but to understand them, accept them, lose a bet occasionally, and — stay in control! A corollary point is that the occasional crisis must also be controlled. To illustrate, the fall of Continental, in my view, was as much due to the blindness of directors *post* Penn Square as it was to the strategy that permitted the Penn Square involvement.

Third, let us not forget that mismanagement of risk must be severe indeed to break a bank. Our study of larger bank failures reveals that each was caused by massive, multiple, and repeated misjudgments. The fall of larger banks is not caused by isolated events, however large. This means that the prudent management of risk is not a superhuman task but a very manageable, indeed a prosaic challenge. Failure simply does not overtake the reasonably prudent and alert banker.

Finally, the banking industry trade and professional associations have, I think, a major role to play. Not only can they assist in managerial consciousness-raising but in showing the public that bankers, after all, understand their business.

An important development of this sort is the emerging proposal of the Association of Reserve City Bankers (ARCB) to self-regulate the risk inherent in wire transfer "daylight" overdrafts. This industry initiative has far greater value than if the Federal Reserve Board were arbitrarily to "cap" the volume of these overdrafts. Under the ARCB proposal, not only can large bank managements play a determining role in guiding and monitoring overdrafts, but the industry would be seen by Congress and the public as itself regulating a large risk frontier.

Bank Administration Institute, the sponsor of this conference, can be uniquely influential as a forum to help the managers of smaller banks master new perspectives on risk. For example, how can bank managers harness credit/investment analysis — the tools of market discipline — as key benchmarks for corporate planning? How can bank directors strengthen their objective assessment of bank performance? How can a common language of bank risk analysis be shared by managers, regulators, investors and funds-providers? Discussion programs of this sort will help bankers establish themselves — with one another, with employees, with investors/creditors, and with regulators — as hands-on managers of the risk process. If not the industry, who else? ■

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The CHAIRMAN. Mr. Keefe.

THE STATEMENT OF HARRY V. KEEFE, JR., FOUNDER-CHAIRMAN, KEEFE, BRUYETTE & WOODS, NEW YORK, NY

Mr. KEEFE. Thank you, Mr. Chairman, for an opportunity to appear before you today.

While the other gentlemen are very long-time friends and I have enjoyed intellectual discussions with Mr. Isaac and Mr. Selby, I have a different point of view as a securities dealer from a firm that has 100 percent of its capital stock invested in bank stocks, as 100 percent of the equity portfolio in employee's profit-sharing plan invested in bank stocks.

So I have a very specific selfish interest in the outlook of the industry. I have some points where I disagree very thoroughly with the regulators, and I know David does.

But in your letter you said to me, "And we improve our ability to assess the condition of the banks and financial institutions," and one of the points there where I agree with both Isaac and Selby, is the quantity and control of the regulatory personnel.

UPGRADE REGULATORS PAY

I think one of the worst jobs in the world is to be a bank examiner. You're on the road all the time. Every bank you go into dislikes you. It's an underpaid, overworked position and, as either Selby or Isaac said, they would like you in the Congress to free up the civil service scales so they can compete in the market for decent people for what I believe is a very difficult job.

We use credit ratings, as does David, and I can tell you right here and now that neither the Comptroller nor the FDIC can compete with people out of business schools or out of the financial marketplace. And I think that's silly.

I think probably the greatest risk reward you can get is to free up the pay scales for examiners in the two agencies and reduce the number of bank failures.

I don't think we need much more timely data. I think there's more data than we and the regulators can digest. Indeed, one of them mentioned that they would get to June call the end of August somewhere in September. We get the same from the Federal Reserve in April and we process them on our computers and give them back to the regulatory agency in mid-April and we find that they don't get them until June.

I think there's a general inertia in the bureaucratic system that doesn't have financial incentives to get somebody in the marketplace, as we do. But, if you improve the quality and quantity of personnel, you improve the analytical techniques. I think the data exists. You have the ability to predict failures from improved techniques.

I think one area of new disclosures that I find that is particularly missing in the nonpublic banks is the breakdown in the loan portfolio which is something that I, as an analyst, have been fighting for 30-odd years.

Indeed, on the back of the call you have some 20 to 22 loan categories, but it doesn't give you industry concentration. From my

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knowledge of bank failures is that a large part of them are not due to fraud, but are due to concentration either in particular companies or in particular industries.

CONCENTRATION OF LOANS

I think it should be made available to those of us on the outside—industry concentrations where an industry is over 5 percent of the total loan. I think the big loans, the recent move by the regulators to permit banks to make loans up to 15 percent of capital, where it used to be 10, is absurd. I think that kind of concentration—to have 15 percent of your capital in one loan is an absolute absurdity, and I think it ought to revert to the 10 percent and maybe lower.

Some of the best managed banks in the country have a 5-percent, self-imposed limit on themselves, and I think companies like Allied, Houston, and Wachovia, wouldn't think of going to 15 percent of their capital on one loan. I think it should be made available to the public for public discipline that every bank should list its 30 largest borrowers by the types of company, like a building company, the oil company, and the amount. The company itself need not be identified.

Some of the serious problems in the industry for us in Chicago—the Bank of America, Inter First, has been neither a company nor industry concentration.

The improvement in salaries and regulatory agencies, talking about millions of dollars in salaries against billions of dollars in losses at FSLIC and FDIC.

We haven't talked much about this today, but I began my work with the banking industry with the New England Mutual Savings Bank and I commend to your committee a study of New England Mutual Savings Bank and as to why we don't have problems in New England.

As a New Englander, I am proud of their record. We don't have problems because we have regulations that prohibit what happened recently in Sunrise Savings in Florida, where 70 percent of their assets went for construction mortgages and where they went from $4 million to $1½ billion in 4 or 5 years. That couldn't happen in New England. You're not having thrift failures in New England. You don't have problems in thrifts.

I think one of the problems we have had with thrifts is that they're whole reason for being has been perverted, and perverted by the Congress, the real estate industry, and builders as a way to pump money into construction, and not as a safe place for people to keep their savings.

I think the use of jumbo CD's by the thrifts has accelerated it. Financial Corp of America is a perfect example—selling jumbo CD's to brokers and their own salespeople who are on commission all over the United States. They're still losing money. I think they lost $17 million in the last quarter.

My partner bought a condominium in Naples, FL. The equity owner of the condominium was Financial Corp of America in Los Angeles. I think that's way beyond what we think of as thrift. They're not condominium risk developers.

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I think the use of jumbos by the thrifts should be limited to a certain percentage of their liabilities—10 percent, whatever. That would prevent this huge accelerated growth.

Now, I disagree with the regulators—and I know David does—in this whole access on capital ratios. Where do we get 5½ percent from? I have been studying this ratio for 30-odd years. I have a few more years on Joe Selby. Where do you get it? Why not 6? I think it's a simplistic answer to a complicated problem.

Mr. Isaac said we should have 9 percent capital ratio because it's better. Why not 12? That would be even better than 9. The reason is that it's not economic. As a securities dealer, my firm is one of the six leading managing underwriters of bank securities and indeed in the last 9 months we have underwritten and managed twice as many bank convertible debt agents as any firm in the business. So I think I have a feel for the debt market and what people who buy this paper that Mr. Isaac proposes to sell, think.

And as David alluded, if you put in such a bill, you're going to kill the community bank that every politician I know loves, because the community bank isn't going to be able to have an access to that market.

We are one of the five or six leading underwriters and we're not going to underwrite $2 or $3 million issuances to the community bank, because there's no market for the paper.

MARKET DISCIPLINE ON QUALITY

There is a market discipline on quality and it exists in the stock market; not in the debt market. Discipline—the discipline Mr. Isaac seek at the riskier bank paying high-interest rates, in fact, does not exist. The lowest price/earnings ratio of any major bank in America is the Manufacturer's Bank of Hanover, which sells at five times earnings, at 6 percent of its book, with its price/earnings ratio only 61 percent of the industry average. Why is that so?

Because the market says that this bank has invested 10 percent of its assets in South America and probably has the largest relative exposure to Argentina, and the market doesn't like that. But it has not affected access to the debt market and it hasn't impeded access to the debt market.

Chase sells at 5.8 times earnings; 6 percent of book and 71 percent of price/earnings. Now I think the stock market is very accurately appraising the risks in these companies, as in the Bank of America. And one of the risks is that they are grossly underreserved. We used the reserve figure—reserves of bad debt—as a percentage of nonperforming assets, in the case of Manufacturer's Hanover and Chase, the Bank of America, that reserve is about 35 percent of their problem loan.

The Wachovia Bank, on the other hand, the reserve is 170 percent of its problem loans, and the market rewards Wachovia with a 10.9 times price earnings ratio against the Manufacturer's Hanover of 5 and Chase's 5.8. So the market is concerned and it is a very good discipline.

The emphasis on debt/capital drive these banks to the debt market for the simple reason they can't sell stock in the equity market. I think one of the problems in this giving ratings by the

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public to get discipline is just what Mr. Selby said. They change the ratings when they have an examination. David and I change the ratings of a company twice. We visit with management in person. We don't wait for call reports. If we have a problem we send a questionnaire. We want to know what's going on.

I think to have Government-devised ratings published is an insane idea. I think the marketplace will provide this. The marketplace is indeed providing it. We provide it to some 600 giant corporations, 400 out of the Fortune 500. Our clients own 50 percent of the jumbo CD market. Ask Barry Sullivan; ask Roger Anderson. When we lower our rating, their access to the market is very much impaired and they know it and they're very conscious of it.

Debt costs vary not so much with the credit perceived, but with the size of the issue. It is a fact of the marketplace that if X, Y, or Z bank came to me, an A-rated bank by Standard & Poor's and wanted to set a $25 million issue or a $100 million issue, I would charge them one-quarter of 1 percent less for the $100 million issue than the $25 million issue.

That seems silly, because the bigger ratio means the company issuing it has more debt. That doesn't make sense, except people who buy the debt issues are large portfolio buyers and the $100 million issue has more liquidity.

Nobody buys debt for 10 years today. More like 10 days, 10 weeks, 10 months. They go into the yield curve or the maturity curve where they think the best opportunity exists. There's no portfolio, any patron fund or an insurance company that has ever had it in its mind when it buys an issue that is going to hold it to maturity. He might, but he might sell it in 10 days and frequently they do. So the bigger the issue, the more liquidity and less ratio.

I disagree very seriously with Isaac's concept that if you separate out risk deactivities, that is, securities, into a separate corporation, that it will not impair the company. I think that's insanity.

If you have Chase Securities Corp., and Chase Securities Corp. goes belly up and gets wide publicity in the New York Times and the Wall Street Journal, just see what success Chase Manhattan Bank has in selling jumbo CD's. You won't be able to give them away, because the marketplace won't distinguish between a separately capitalized risk venture. It just doesn't do that.

We operate in that business and we know what these people who buy jumbo CD's, how their mind works. And the proof of that is the banks who got involved in real estate investment trusts [REIT's] back in the 1970's—the Hartford National, American Fletcher, Chase Manhattan Bank—they were separate, they had nothing to do with the bank, but it impaired the bank's ability to access their jumbo CD market.

I think one of the improvements on disclosure data would be monthly data. Certainly, out of the 200 largest banks. I started as a railroad analyst and the railroad utility companies have done this for years. With computers, it's no burden, and we would be able to discern if a bank is weak—that is, David and I and others, the financial marketplace. I don't think it's a burden at all.

My associate, Dr. Sanchek, has presented a paper to you which I won't comment on. It talks about risk-based capital and risk-based

Government insurance. And that has been given to your staff so you can review it.

Thank you very much.

[The complete prepared statement follows:]

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Written Statement by Andrew M. Senchak, Keefe, Bruyette & Woods Inc., Concerning Depository Insurance

Testimony Outline, July 23, 1985

Mr. Harry V. Keefe, Jr.
Chairman, Keefe, Bruyette & Woods, Inc.

1. The ability to assess the condition of financial institutions can be improved by

   1) improving the quantity and quality of personnel which will

   2) improve the analytical techniques;

   3) additional or more timely data is not the critical factor,

   4) Qualitative judgement should be enhanced,

   5) too often excessive reliance upon quantitative factors makes more difficult correct judgements concerning credit quality.

2. We believe that expanded powers for savings and loan institutions have resulted in a substitution of credit risk for interest rate risk. Their ability to deal with the latter is significantly superior to their ability to deal with the former.

3. The rapid growth experienced by a number of recently failed or distressed depository institutions has been underwritten by the implicit and or explicit deposit insurance provided by the practice of breaking up jumbo CD's into $100,000 amounts.

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Just as the FED, FDIC, and OCC have adopted uniform total capital ratios, study has begun on a proposal to increase these ratios to the neighborhood of 9% of assets from the newly established uniform level of 6%. This proposal is being studied in conjunction with one for modifying the deposit payoff procedure for failed banks. What do these proposals have in common? A desire to expose the banking system to increased market discipline. The source of this desire is a perceived increase in the riskiness of depository institutions' activities resulting from the continuing deregulation of the financial services industry. The increased frequency of bank failures has posed a threat to the "integrity" of the funds insuring the deposit system. Such a threat is worthy of considerable concern. Recent events in Ohio and Maryland are, fortunately, small scale illustrations of the events which unfold when depositors doubt the capacity of their insurance fund to fulfill its obligations. Similar doubts cast upon the FDIC fund would, if acted upon, cause enormous dislocations in our national economy.

We view the proposals as two aspects of an attempt to, at least in part, supplement the discipline of the market for that of regulators. Given our economic system there is little arguement, in a theoretical sense, that the benefits of a successful attempt to make such a change outweigh the costs. By adding the scrutiny of depositors and investors to that of regulators, market forces are brought into play, as both depositors and investors, on the basis of their preferences concerning risk and return, acquire and dispose of deposits and securities. Such activity causes movements in yields and asset prices. These movements are signals reflecting the assessments of diverse parties regarding the riskiness of a deposit or an asset and the necessary compensation for bearing that risk. This compensation is a cost borne by a bank; riskier banks will have higher funding and capital costs. By raising capital requirements and utilizing the modified payout procedure the FDIC believes that, by making a banks funding and capital costs reflect the riskiness and growth of its assets, the banking system and the insurance fund will be safer and sounder.

This article is divided into three sections: a description of and our comments on the modified payout proposal are contained in the first; similiar treatment of the increased capital requirement is contained in the second; the third is a summary and conclusion. In discussing each proposal we also consider, to a lesser degree, risk adjusted insurance premiums and risk adjusted capital ratios.

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I. The Modified Payoff Proposal

The funding of assets with liabilities whose cost is a function of the assets' riskiness sharply contrasts with the funding of assets by insured deposits. Because the present FDIC insurance premium does not vary with the riskiness of the assets being funded the trade off between risk and return is damaged in two ways: one is that depositors' incentive to both determine and respond to the riskiness of a bank's balance sheet is diminished; the second is that banks do not bear the cost of acquiring riskier assets The bearer of this cost? The FDIC insurance fund.

It has been argued, in both academic journals and governmental studies, that risk adjusted insurance premiums are the solution to this problem; by having the deposit insurance premium vary with riskiness of the bank's assets the cost of acquiring riskier assets is borne by the acquiror. This solution has been criticized because it requires the FDIC to determine the riskiness of a bank's assets and place a price on the bearing of that risk. The latter requirement is objected to because, in our economic system, prices are determined by market forces (supply and demand) and in the case of deposit insurance there is no market because there is no supplier - other than the FDIC. Thus, in a system of risk adjusted insurance premiums, given the current absence of non-governmental insurance funds, the FDIC would substitute for market forces. As a result of this, it would be a governmental agency that would be sending signals to the market, in the form of changing insurance premiums, concerning the riskiness of individual banks.

In general we believe that deposit insurance has many of the characteristics of a public good; one which masurance there is no market because there is no supplier - other than the FDIC. Thus, in a system of risk adjusted insurance premiums, given the current absence of non-governmental insurance funds, the FDIC would substitute for market forces. As a result of this, it would be a governmental agency that would be sending signals to the market, in the form of changing insurance premiums, concerning the riskiness of individual banks.

In general we believe that deposit insurance has many of the characteristics of a public good; one which market forces, driven by profit, have failed to supply. For this reason we believe that a governmental attempt to create prices for services the market has failed to supply has considerable practical difficulties (such as the "announcement effect" surrounding an increased insurance premium) which outweigh the beneficial effect of risk adjusted premiums.

The modified payoff proposal* is an attempt to introduce depositor discipline while keeping the FDIC out of the business of establishing risk adjusted insurance premiums. Currently, although over 80% of all deposits are insured, and although over 90% of deposits in a "substantial majority" of banks are insured, the present practice of dealing with most larger (above $100m) bank failures through purchase and assumption transactions provides defacto 100% insurance coverage. The modified payoff procedure would eliminate the 100% de facto coverage by paying off deposits in excess of the maximum insurable amount on the basis of the estimated present value of the failed bank's receivership collections. This method gives those depositors whose accounts are in excess of the maximum insurable amount an increased incentive to monitor and respond to the riskiness of their bank.

*Please see the Keefe Banking Industry Study, "Changing Policy at the FDIC: No More Guarantees" of May 26, 1983 for a more detailed description of the proposal.

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As a general co[illegible] we strongly endorse depositor diligence but look upon the exercise of depos[illegible] discipline with ambivalence. We recognize that, in order for banks to optimal[illegible] adjust their portfolios by balancing risk and return, the acquisition of riskier assets must be accompanied by increased funding costs. However, it is our opinion that, although depositors do not reject and in many cases require compensation for placing funds with "riskier" institutions, the degree of riskiness depositors are willing to tolerate is very limited.

To illustrate this point it may be useful to consider the market for term CDs. Term CDs are usually offered in denominations of $1 million for periods ranging from one to five years and are bought by institutions, such as pension funds, which are active in asset/liability management. Because of their denomination, term CD's would be subject to the modified payout procedures. In a recent study by KBW of term CD placements during the period from January 1981 through April 1984 it was found that the spread to Treasuries ranged from 10 to 300 basis points. However, the riskiness of the banks issuing these CD's was contained within a narrow range; of the 218 transactions studied, 85% were companies rated within KBW's top three ratings.

Our point is that, at least in the term CD market, depositor discipline is currently being exercised. The primary component of this discipline is the diligence done to determine whether or not the issuer meets the minimum credit standard; the secondary component is the determination of compensation for bearing marginal risk once the minimum criteria have been met.

Our ambivalence concerning the exercise of depositor discipline is a function of depositors' minimum standards. When a bank falls below these standards exercise of depositor discipline results in deposit funds being withdrawn; for those larger, money center banks, who may rely more heavily on "purchased" (such as brokered term CD's) as opposed to "core" deposits, this form of discipline is stressful, indeed. In the case of capital instruments, when a banking company's creditworthiness is thought to weaken, market prices fall and yields rise so as to compensate prospective investors for bearing the risk that current investors, now selling their assets, no longer wish to bear. The problem is that a deposit is not designed to be an efficient means of bearing and or transferring risk in the way a capital asset is. However, if a money manager were primarily interested in bearing risk and being compensated for doing so then he would not be acquiring deposits. Thus, the willingness of a depositor to be compensated for bearing increased risk is very small. After some point, and the KBW study of term CD placements suggests that, for some money managers, this point is our third highest rating, no reasonable amount of compensation via higher interest rates is capable of inducing a depositor to bear additional risk.

This point is worth pursuing. Much concern has been generated by the emergence of brokered term CDs placed with banks willing to pay extremely high rates. We view the fact that many of these banks are in serious difficulty as a manifestation of an aspect of the credit relationship falling into the area which economists call "adverse selection". The essence of adverse selection is that the willingness of a bank to pay extremely high rates is a reflection of the bank's relatively strong appetite for risk taking; high rates become a signal to the market that the bank is riskier.

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It may be argued that this is the way the market is supposed to work. Depositors willing to accept more risk are compensated for doing so. But, this is not the case for two reasons. The first is that the Purchase and Assumption method of disposing of failed banks, provides de facto 100% coverage for all depositors. For this reason, we strongly endorse the modified payoff proposal; it will contribute to the transfer of risk onto those who are being compensated for bearing it. Secondly, the breaking up of brokered term CD's in $100,000 amounts so as to qualify for insurance coverage insulates depositors from the risk taking activities of banks and, unfortunately, wets the appetite for risk taking by the "weaker" institutions (S&L's, credit unions, etc.) making such deposits. According to the FDIC, banks rated 3,4 and 5 on the uniform bank rating system hold 38% of brokered deposits. We believe that a large part of the depositor discipline which already exists in the market is being eliminated by breaking up brokered term CDs and strongly endorse measures taken in curbing such abuse of the insurance fund.

In conclusion, we support the modified payout proposal; assert that depositor discipline already exists in the brokered CD market, much of which is regrettably dissipated by the breaking up of term CD's; believe that there are occasions when the potential exercise of depositor discipline is much more desirable than its actual exercise; and express doubt concerning the practicability of risk adjusted insurance premiums.

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II. The Proposal To Increased Capital Requirements

The FDIC has proposed raising required capital ratios by a substantial amount. Although the exact level is not critical, 9% has been mentioned with as much as one third of the requirement being met by subordinated debt, if so desired. The new requirement would be phased in over a period of several years which would allow flexibility in adjustment to it by the banks and markets. We offer comments on selected theoretical and practical aspects of the proposal.

From a theoretical perspective, increased capital requirements have a certain appeal. Raising capital requirements raises the proportion of assets financed by liabilities whose price and yield are more suited to reflecting the trade off between risk and return than are deposit type liabilities. Because market participants determine price and yield via their assessment of and preference for risk and return and, as more of funding costs are determined primarily in this fashion, then the marginal cost of risk is more fully reflected in funding costs. Under normal circumstances increasing the cost of funding risky assets will result in fewer purchases of such assets. The benefits of this are three folo: 1) the chances of a bank failing are reduced; 2) as banks become troubled, there is a greater cushion of capital separating the FDIC insurance fund and the insured deposit liabilities; 3) growth, particularly risky growth, becomes more hostage to securities market access, not just deposit funds access.

There are some drawbacks to raising capital requirements. These drawbacks stem from the paradoxical nature of the proposal: raising the capital requirement in order to introduce market discipline is paradoxical because the market itself has not required such ratios. Because of this it is quite likely that the competitive nature of the banking system will force banks to minimize the effect of the regulation. Here we believe that it is worth emphasizing that our domestic banks compete, not only with each other, but also with foreign banks and, increasingly so, with other non bank financial services deliverers. One such way of minimizing the impact of the regulations would be to increase off balance sheet activities as a means of conserving on capital. The FDIC has recently estimated that the nations' 15 largest bank holding companies have $929.6 billion in off balance sheet liabilities compared with $852.2 billion in total balance sheet assets. If 25% of the off balance sheet liabilities became assets, then current primary capital ratios would fall by 20% or to approximately 5.2% of total assets. We do not believe that the current capital requirements are the sole or even the major contributor to off balance sheet activity, however we do believe that raising capital requirements will accelerate this activity.

A second way in which competitive forces would force banks to minimize the impact of the increased capital requirement would be for banks to attempt to raise their return on assets, thereby maintaining their rate of return on equity. ROA's would be depressed by the increased capital requirement because of the negative spreads on the subordinated debt. Such spreads are a function of the overall quality of a banking company and also its size. Banks under one billion dollars in assets may be required to pay increased spreads to Treasuries on the basis not only of their absolute size but also their size relative to competitors within the relevant market. This will generate an incentive to accept more rather than less risk for banks penalized purely on the basis of size and not quality.

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We recognize that, in theory, an increase in off balance sheet items or an increase in the riskiness of a bank's assets would cause the marginal cost of capital to increase. Thus the higher capital requirement would provide a disincentive for most banks to take such measures - however for those relatively less risk adverse banks, the ones about which the FDIC is most concerned, the incentive for more risk taking, we believe, would be increased.

In summary, from a theoretical perspective we feel that the most significant impact on the banking system of increasing the capital requirement would be to enhance the capital cushion separating the FDIC fund from insured depositors; the impact of the increased capital requirement, we believe, would have less impact on the risk taking activities of banking companies as a whole - some would reduce their risk taking, others increase it.

In contemplating the practical aspects of implementing the proposed 9% requirement there appears to be some merit in the remark that it is an "investment bankers relief act". However distastefully cynical such a remark may strike us, we are compelled to reveal that, had the 9% requirement gone into effect at year end 1984, FDIC insured commercial banks would have been attempting to raise approximately $46 billion in capital, roughly three and two thirds the amount raised in 1984*.

To place such a sum in perspective we offer the following calculations: 1) as a percentage of 1984 total net borrowing by the entire financial sectors it is 35%; 2) as a percentage of 1984 total net borrowing by all sectors of the economy it is 5.3%; 3) as a percentage of 1984 net savings by the household sector it is 16.9%. Should a 9% capital requirement become a reality, investment bankers may experience relief followed by indigestion.

Does the situation improve if the requirement were to be phased in over, say, a five year period? Yes, but not by much. Figure I below is a projection of the capital requirement for 1985 through 1990 for FDIC insured commercial banks**. Assuming a 9% growth rate in total assets, an ROA of 80 b.p., and a payout ratio of 30%, the banks would have to raise $70.6 billion by year end 1990. This is an average of $14.12 billion per year for the next five years. Over the last five years banks have raised an average of $6.25 billion per year.

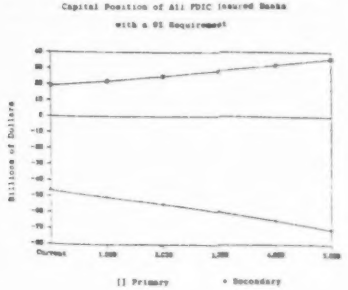

Figure I

*According to Irving Trust's, "Capital Securities Issued: Commercial Banking Report 116", $12.544 billion was raised in 1984 in 133 separate financings.

**Please see the Appendix for our projection.

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It is generally agreed that larger banks have superior access to the capital markets. From this comes the conclusion that the capital requirement proposal would discriminate against smaller banks. Such discrimination, it is argued, would be mitigated if banks were permitted to purchase the subordinated debt of their downstream correspondents. This suggestion has a drawback. It is true that the capital cushion of any single bank would be increased under the correspondent arrangement but, to the degree that interbank holdings of subordinated debt make up the capital requirement, the capital cushion of the system as a whole will not be enhanced. This fact reduces the boost given to the "integrity" of the insurance fund by the 9% requirement.

In fact, from a practical viewpoint, the 9% requirement may be more onerous for some large banks than smaller banks. As mentioned, large banks have greater access to the capital market, but some also have a greater need for capital, primarily as a consequence of being relatively less capable of generating capital internally. In order to illustrate this point, we have projected BankAmerica Corporation's capital needs over the next 5 years under a 9% total capital and 6% primary capital need. Our assumptions were: 40 b.p. ROA, a growth rate of 4.5%, a payout ratio of 50%. The results, illustrated in Figure II show that, although the primary capital need would increase by only 100 million, the total capital need would increase from $2 billion to $3 billion over the five year period. The good news is that the total capital requirement, as a percentage of accumulated capital, would increase moderately, from 23% to 29%. Obviously, if these amounts were not achievable the bank could grow more slowly. Indeed, if it choose to remain at its current size it could achieve the total capital requirement, without going to the market, in somewhat more than eight years, after that it could grow at slightly over 2% per year.

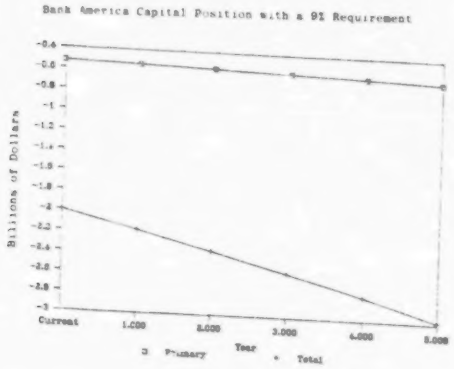

Figure II

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In many ways the BankAmerica illustration is the extreme case: its current capital need is robust, even under the 6% requirement; its ability to generate capital internally is pushed down by a high payout ratio and a low ROA. But the fact remains that under the 9% requirement this single banking company would need to raise, over the next five years, almost one quarter of the funds raised by the entire banking industry in 1984.

The magnitude of the impact on the market for bank capital of the 9% proposal leads us to conclude that imposition of such a requirement would significantly slow the growth of the banking system.

At present the banking system is capable of internally generating sufficient capital to grow at 7.8% a year while maintaining a capital ratio of 7.2%. If the requirement were 9%, the system would grow, on the basis of internally generated capital, at 6.2% per year - assuming the $46 billion had already been raised. This comparison of steady state rates of growth suggests that, during the period necessary to raise capital ratios to 9% the system would be constrained to grow at no more than 6% per year. With the economy growing at between 6% and 9% per year (in nominal terms) we conclude that the banking sector would forced to reduce its share of the financial services industry.

Perhaps such a reduction is a desireable goal; however, we are not convinced that it is either consistant with improving the safety and soundness of the banking industry nor that it is an appropriate price to pay for reducing the risk taking activities of a subset of banks and improving the capital cushion for the depository insurance fund. We find much more appeal in the idea that capital ratios should be adjusted for the riskiness of the assets against which the capital is held. This puts the burden of adjustment on banks - they are required to allocate their scarce capital across a set of risk taking activities according to their preferences for risk and return. Additionally, risk adjusted capital ratios do not require any regulatory authority to send a signal to the market regarding its opinion of the riskiness of the bank.

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III. Summary and Conclusion

We strongly endorse the idea that enhanced market discipline will reduce the risk taking activities of most depository institutions and, consequently, reduce the threat to the integrity of the FDIC deposit insurance fund. Our opinion is that the modified payout proposal would enhance market discipline as exercised by depositors but that there is considerable depositor discipline already in existence in the brokered CD market. However, much of the discipline this market is capable of exercising is dissipated through the practice of breaking up jumbo CDs into denominations fully covered by FDIC insurance.

We also conclude that the deposit liabilities of banks are inferior to capital market type liabilities as a means of mediating the trade off between risk and return. We especially regard the exercise of depositor discipline via the withdrawal of funds as, in itself, quite capable of threatening the integrity of the deposit insurance fund.

Finally, although there is theoretical appeal in the introduction of a 9% total capital requirementfrom the perspective of the cushion available to the FDIC, it practical implemtation is onerous. We conclude that its implementation would have the most significant impact on the growth of banking companies and, to the degree that slower growth means less risk taking, then the safety and soundness of the industry is, in this respect enhanced. However, we are compelled to add that this improvement is somewhat artifically the result of capital market discipline since it is the result of a regulatory rather than market determined requirement. Such artificiality, we believe, would cause banking companies to seek means to minimize the impact of a 9% requirement on their profitability and growth. Such means would be contrary to enhancing the safety and soundness of the commercial banking system.

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The CHAIRMAN. Mr. Homan.

STATEMENT OF PAUL M. HOMAN, FORMER SENIOR DEPUTY COMPTROLLER FOR BANK SUPERVISION, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. HOMAN. Thank you very much, Mr. Chairman.

I will try to be very brief but I would like my full statement in the record.

The CHAIRMAN. It will be.

Mr. HOMAN. The adverse economic environment in the financial marketplace in recent years has created increased risks for financial institutions of all types.

The natural result has been increased numbers of bank failures, near failures, and financially troubled institutions. Questions have naturally been asked by a number of constituencies about the overall record of the bank supervisory and insurance agencies managing and handling the troubled banks and the failure situations of the last few years.

During such periods of economic and market turbulence, the principal public policy objectives in supervising banks and managing failures are to preserve the integrity of the banking system, after all, and to maintain the public's confidence in it.

At the same time, these objectives should be accomplished in the least costly way to bank depositors, the agencies, the industry, and the Federal Deposit Insurance funds.

RECORD OF REGULATORY AGENCIES HAS BEEN GOOD

I would like to say at the outset that measured against the public policy objectives just described, the record of the bank regulatory agencies has been quite good, in my opinion, given the magnitude of the problems and the resources available to the agencies.

The agencies have been both imaginative and effective in identifying and resolving troubled banking situations which collectively, and sometimes individually, might have seriously eroded confidence in the banking system, had they been managed less effectively.

While the overall performance of the agencies has been reasonably good, I believe they would agree with me that mistakes in judgment were sometimes made in the handling of certain bank failures, that certain situations might have been handled earlier at less cost to the Government and that room certainly exists for improving the examination, supervision, and deposit insurance processes.

With respect to these functions, the committee has asked for comment on several general areas:

One of these is how can we improve our ability to assess the condition of financial institutions? I wish to focus on that question. There is no question that better data, more timely data, additional sources of information, improved analytical techniques, and more sophisticated financial modeling and rating analyses will, along the lines discussed by the two gentlemen on my right, improve the ability of the bank regulatory agencies and private industry to assess the condition of financial institutions.

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But progress in this area has been seriously impaired in recent years by the various Paper Work Reduction Acts and legitimate general concerns about increasing the reporting burden of financial institutions.

The result of such legal and self-imposed restrictions has created an information gap for bank analysts, both public and private. This is especially true for smaller banks which had been exempted from reporting much of the detailed information required of medium- and large-sized banks.

As a way of closing this information gap, Congress should consider exempting the regulatory agencies from paper work reduction laws. The agencies should be able to exact the data they require for better analysis without greatly increasing the reporting burden of financial institutions.

The quality and integrity of financial data received by the agencies are also crucial to bank's supervision, analysis, and examination. Yet there is evidence to suggest that both data quality and integrity have diminished during the 1980's for several reasons.

NEED FOR ONSIGHT EXAMINATIONS

First, and I believe most important, there has been a steady decline in the number of comprehensive general onsight examinations. There is no adequate substitute for the onsight examination in gathering and verifying good quality financial information. And without good quality data, the best analytical and supervisory processes become suspect and prone to error.

The decline in comprehensive general examinations has been the result of absolute staff reductions at the banking agencies and reduced staff relative to the increased size and complexity of the banking industry.

At the same time, increased economic volatility, more competition, and a deregulated environment have resulted in a riskier financial marketplace and a concomitant increased number of troubled banks and bank failures. Troubled banks have more than tripled since the early 1980's to over 900 institutions; and, as Mr. Isaac described this morning, now equal approximately 1,000 institutions. Examining, analyzing, supervising, enforcing, and, if necessary, managing the failure of troubled institutions takes a tremendous toll on examining and supervisory manhours. To handle both this increased workload and Government-imposed staff reductions, the agencies have been forced to allocate limited human resources away from the comprehensive general onsight examination and accept what I considered to be inadequate substitutes.

The whole process has thus suffered from the lack of quality data on an increasing number of banks. The obvious cure is for the Congress and the executive branch of Government to assure that the banking agencies have the people to do the job.

Increased fraud and the increased reluctance of bank owners and management to report realistic financial results have also been contributing factors to the decline of both the quality and integrity of data being received by bank regulators.

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Again, the root causes of both are related to a more risky, uncertain, and volatile economic and financial marketplace environment.

Such an environment takes a heavy financial toll on marginal banks, creating desperate circumstances for the managers involved. In attempts to sidestep, postpone, or avoid altogether, the consequences of reporting a significant decline in earnings or major loss, bankers will sometimes refuse to face economic reality and will delay or fudge the recognition and recording of losses and other bad news. Outright fraud also greatly increases during such times and still heads the list of factors contributing toward most bank failures.

One check against unrealistic financial reporting and outright fraud is the onsight general examination. Another is an opinion audit by a certified public accountant. In the past, cost considerations, especially for smaller financial institutions operating in a more normal, stable economic and banking environment, may have outweighed the benefit of requiring CPA audits for all banks.

But in today's environment this is no longer true. Requiring audits would greatly improve the quality and integrity of data being disseminated not only to bank regulators but also bank customers, depositors, creditors, investors, private analysts, and the general public as well. Congress should seriously consider legislation to accomplish this end.

In the fraud area, Congress also should free up the ability of regulators and law enforcement officials to cooperate, coordinate, and exchange information. This can be accomplished by addressing and changing certain privacy and grand jury secrecy laws.

But, the most important factor in assessing the condition of a financial institution continues to be the quality of the examiner or supervisor making the assessment.

It should, therefore, come as a surprise to no one that the best way to improve our ability to examine and supervise banks is to increase the quality of well-trained, highly qualified, and experienced professional examiners and supervisors.

But just the opposite seems to have occurred in the last few years. Significant staff reductions have occurred despite the rise in troubled institutions, the growth of the financial services industry, and its increasing volatility and complexity. More important, a large number of experienced, sophisticated examiners and supervisors have left because the agencies could not compete with the private sector in offering comparable salary and benefit packages. And I couldn't agree with Mr. Keefe more in that respect.

Staff reductions, coupled with the loss of experienced personnel, have, in my opinion, reduced the overall managerial quality of the bank regulators, especially at the midmanagement levels. The agencies are fortunate to have retained sufficient numbers of experienced and competent senior examiners, supervisors, and managers who have thus far managed to prevent a serious erosion of the agencies' effectiveness.

Nevertheless, these human resources are stretched too thin and cannot be expected to continue to work effectively under such strained conditions, nor can they be expected to stay with the agen-

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cies unless their salary and benefits are brought more in line with those available in the private sector.

This issue has long been neglected and should be addressed by the Congress and the Executive if we are to achieve an improved and more effective financial examination and supervision system.

Mr. Chairman, in the interest of time I will conclude my comments here.

I have commented on the areas of disclosure, enforcement activities, capital standards, and risk-based deposit insurance in my statement and made some suggestions for improvement in that regard and I would be glad to answer questions on those issues and any others that you may have.

Thank you very much.

[The complete prepared statement follows:]

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STATEMENT OF

PAUL M. HOMAN

JULY 23, 1985

I am very pleased to have the opportunity to provide a statement and participate in these hearings. While the Committee's interests in pursuing these hearings are wide-ranging, involving a number of important issues and topics, I have limited my comments to those general areas of bank supervision in which I have special experience by background and training. I will be happy to respond to any questions on these or other issues to the best of my ability. The views expressed here are my own, and should not be attributed to my former employer, the Office of the Comptroller of the Currency, or my current employer, Continental Bank.

The vicissitudes of the economic environment and the financial marketplace in recent years have created increased risks for financial institutions of all types. The natural result has been increased numbers of bank failures, near failures and financially troubled institutions.

Inevitably and appropriately, such an environment brings into focus the policies and performance of government in the fields of bank supervision and deposit insurance. Because the number of financially troubled institutions and failures have increased so dramatically, legislative and media interest in bank supervision recently has exceeded any other period since the Depression. Questions have naturally been asked about the overall record of the bank supervisory and insurance agencies in managing and handling the troubled banks and the failure situations of the last few years.

During such periods of economic and market turbulence, the principal public policy objectives in supervising banks and managing failures are to preserve the integrity of the banking system and to maintain the public's confidence in it. At the same time, these objectives should be accomplished in the least costly way to bank depositors, the agencies and the federal deposit insurance funds.

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I would like to say at the outset that measured against the public policy objectives, just described, the record of the bank regulatory agencies has been quite good given the magnitude of the problems and the resources available to the agencies. The agencies have been both imaginative and effective in identifying and resolving troubled banking situations which collectively, and sometimes individually, might have seriously eroded confidence in the banking system, had they been managed less effectively.

While the overall performance of the agencies has been reasonably good, I believe they would agree with me that mistakes in judgment were sometimes made in the handling of certain bank failures, that certain situations might have been handled at less cost to the government and that room certainly exists for improving the examination, supervision and deposit insurance processes. With respect to these functions, the Committee has asked for comment on the following questions.

1. Can we improve our ability to assess the condition of financial institutions?

There is no question that better data, more timely data, additional sources of information, improved analytical techniques and more sophisticated financial modeling and rating analysis will improve the ability of the bank regulatory agencies to assess the condition of financial institutions. Such improvement will enhance their ability to identify and deal with troubled situations early enough to resolve the difficulties or at least mitigate the financial and public impact.

Further improvements in analysis, financial modeling and rating systems are largely dependent on the ability of the agencies to obtain more quality data and more timely data from financial institutions. Progress in this area has been seriously impeded in recent years by the various paper work reduction acts and legitimate general concerns about increasing the reporting burden of financial institutions. The result of such legal and self-imposed restrictions has created an information

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gap for bank analysts, both public and private. This is especially true for smaller banks which have been exempted from reporting much of the detailed information required of medium and large-sized banks. As a way of closing this information gap, Congress should consider exempting the regulatory agencies from paper work reduction laws. The agencies should be able to exact the data they require for better analysis without greatly increasing the reporting burden of financial institutions.

The quality and integrity of financial data received by the agencies are also crucial to bank supervision, analysis and examination. Yet, there is evidence to suggest that both data quality and integrity have diminished during the 1980's for several reasons.

First, and most important, there has been a steady decline in the number of comprehensive general on-site examinations. There is no adequate substitute for the on-site examination in gathering and verifying good quality financial information. And without good quality data, the best analytical and supervisory processes become suspect and prone to error. The decline in comprehensive general examinations has been the result of absolute staff reductions at the banking agencies and reduced staff relative to the increased size and complexity of the banking industry.

At the same time, increased economic volatility, more competition and a deregulated environment have resulted in a riskier financial marketplace and a concomitant increased number of troubled banks and bank failures. Troubled banks have more than tripled since the early 1980's to over 900 institutions. Examining, analyzing, supervising, enforcing and, if necessary, managing the failure of troubled institutions take a tremendous number of examining and supervisory man-hours. To handle both this increased work-load and adhere to government imposed staff reductions, the agencies have been forced to reallocate limited human resources away from the comprehensive general on-site examination and accept

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inadequate substitutes. The whole process has thus suffered from the lack of quality data on an increasing number of banks. The obvious cure is for the Congress and the Executive Branches of government to assure that the banking agencies have the people to do the job.

Increased fraud and the increased reluctance of bank owners and management to report realistic financial results have also been major contributing factors to the decline of both the quality and integrity of data being received by bank regulators. Again, the root causes are related to a more risky, uncertain and volatile economic and financial marketplace environment.

Such an environment takes a heavy financial toll on marginal banks, creating desperate circumstances for the bank managers involved. In attempts to side-step, postpone or avoid altogether the consequences of reporting a significant decline in earnings or a major loss, bankers will sometimes refuse to face economic reality and will delay or fudge the recognition and reporting of losses and other bad news. Outright fraud also greatly increases during such times and still heads the list of factors contributing toward most bank failures.

One check against unrealistic financial reporting and outright fraud is the on-site general examination. Another is an opinion audit by a Certified Public Accountant. In the past, cost considerations, especially for smaller financial institutions operating in a more stable economic and banking environment, may have outweighed the benefit of requiring CPA audits for all banks. But in today's environment, this is no longer true. Requiring CPA opinion audits would greatly improve the quality and integrity of data being disseminated not only to bank regulators but also to bank customers, depositors, creditors and investors, private analysts and the general public as well. Congress should seriously

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consider legislation to accomplish this end. In the fraud area, Congress should also free up the ability of regulators and law enforcement officials to cooperate, coordinate and exchange information. This can be accomplished by addressing and changing certain privacy and grand jury secrecy laws.

The most important factor in assessing the condition of a financial institution is the quality of the examiner or supervisor making the assessment. Excellent data, timely data and the best analytical and modeling techniques have not and will not substitute for a well trained, experienced, professional examiner/supervisor with common sense and good judgment.

Modeling, forecasting, ratio analysis, rating systems and other analytical techniques using quantitative data have become very sophisticated and increasingly useful tools for bank analysts, public and private, during the last ten years. Yet, no quantitative magic formula, ratio, model, rating system or analytical technique has been developed or found to accurately assess the condition of a bank. This is because the assessment of a financial institution's condition is basically subjective in nature. More subjective than objective factors need to be taken into account in correctly assessing capital adequacy, asset quality, management, earnings and liquidity, which are the principal determinants of a financial institution's condition. Again, whether these assessments are made accurately depends principally on the quality and ability of the people making the assessment.

It should come as a surprise to no one that the best way to improve our ability to examine and supervise banks is to increase the quantity of well trained, highly qualified and experienced professional examiners and supervisors. But just the opposite seems to have happened in the last few years. Significant staff reductions have occurred despite the rise in troubled institutions, the growth

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of the financial services industry and the increasing volatility and complexity of the financial marketplace.

More important, a large number of experienced, sophisticated examiners and supervisors have left because the agencies could not compete with the private sector in offering comparable salary and benefit packages.

The staff reductions, coupled with the loss of experienced personnel, have, in my opinion, reduced the overall managerial quality of the bank regulators, especially at the mid-management levels. The agencies are fortunate to have retained sufficient numbers of experienced and competent senior examiners, supervisors and managers who have thus far managed to prevent a serious erosion of the agencies' effectiveness. Nevertheless, these human resources are stretched too thin and cannot be expected to continue to work effectively under such strained conditions, nor can they be expected to stay with the agencies unless their salary and benefits are brought more in line with those available in the private sector. This issue has long been neglected and should be addressed by the Congress if we are to achieve an improved and more effective financial examination and supervision system.

2. Based on condition, size or other criteria, how should laws and regulations differentiate between institutions?

The Committee has asked for comment in the areas of disclosure, enforcement activities, capital standards and risk based deposit insurance.

-- Disclosure

Disclosure by banking institutions once was not on a par with companies in other industries, but in the last ten years bank disclosure has caught up with and surpassed that of most other industries. This has resulted in better informed

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bank depositors, customers, creditors, investors, market analysts and other bank constituencies influencing bank behavior. This enhanced disclosure has enabled these constituencies to do a much better job in exerting market discipline on marginally performing banks and bank managements. Good disclosure of the type now required has had very positive effects and can supplement and sometimes substitute for bank supervision initiatives. To the extent this supplemental/substitution effect occurs, the desired goal of reducing the government's role in disciplining and influencing bank behavior can be accomplished.

Disclosure can also be dangerous. Poor quality disclosure, certain types of incomplete disclosure, too much disclosure, can sometimes lead to misunderstanding, erroneous analysis, damaging rumors and unfettered markets which can imperil financial institutions, whether deserved or not, and greatly reduce the ability and the time-frame for the government and the private sector to find a reasonable solution with the least possible adverse impact on the general public and the financial marketplace. To avoid these dangers, the regulators have generally pursued a policy of gradually and incrementally requiring and encouraging the increase in the quantity of bank information disclosed to the public. This policy has been pursued effectively and should continue at about the same pace, with a healthy degree of caution as to requiring any new disclosure which may result in deleterious effects on undeserving financial institutions.

Disclosure is not useful unless the quality of the information is good. As I indicated above, there is much room to improve the quality of bank information disclosed to the public and this can be accomplished, in part, by pursuing the suggestions made earlier in this statement.

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One issue of disclosure deserves special comment and that is whether or not enforcement actions should be disclosed to the public. I feel very strongly that disclosure of Cease and Desist Orders and other types of enforcement actions should be limited to summaries of only those provisions in the actions which have a material impact on the bank's condition. SEC reporting requirements should be the method used to keep the public and the financial markets informed as to enforcement actions. The fact of an enforcement action is not important, per se, and when disclosed is often misunderstood by the press, analysts and others to the unnecessary detriment of the financial institution, its depositors and stockholders. Enforcement actions are undertaken against financial institutions with widely differing financial conditions. Some may be close to failure, but the vast majority have only remote prospects for failure or further deterioration. Because of this, the type of remedy sought differs in kind and in severity. Some provisions may be material; others may not. Frequently, the enforcement action as a whole is not material to the financial condition of a bank. Despite the broad differences in enforcement actions, it has been my observation that once the action is leaked or disclosed, there is a tendency for the general media, analysts and other observers, most of whom should know better, to lump together all institutions operating under enforcement actions as if they were all experiencing the same degree of difficulty. Until the public and the marketplace gain a better understanding of the intent, possible effects, substance and materiality of enforcement actions, extreme caution ought to be exercised in disclosure of enforcement actions beyond summaries of material provisions.

-- Enforcement Activities

With regard to enforcement activities, each of the agencies has long had enforcement policies generally based on the condition of the bank. Normally, the worse the condition of the bank, the stronger the remedy and the stronger

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the type of action. For example, a "3" rated bank under the CAMEL rating system may receive a Memorandum of Understanding with some rather mild provisions designed to remedy the problems in the bank. A "5" rated bank in much worse condition will probably receive a Cease & Desist Order containing strong remedies and prohibitions.

I believe the present enforcement policies of the agencies have been reasonably effective and need not be changed significantly. Nor do I think that further enforcement powers for the agencies are necessary, with one possible exception. As a way of raising capital for institutions close to failure and after other methods to raise capital have been exhausted and due notice given, I believe the agencies should have the power to require a merger before a book insolvency occurs. Moreover, to enhance the prospects that a suitable and willing merger partner can be found, Congress should permit qualified interstate banks and bank holding companies to merge or buy the failing institution if such can be accomplished with no assistance from the FDIC.

-- Capital Standards

Regarding capital adequacy, the Committee is interested in comments about risk-based capital. As I indicated above, the analysis of the condition of a bank is primarily subjective in nature. This is especially true of capital adequacy. It is equally true that no formula or ratio exists as an accurate proxy for measuring capital adequacy. No amount of capital short of 100% of total assets is enough if all depositors and creditors lose confidence in a bank. On the other hand, banks can and have operated for substantial periods of time with little or no capital. But such is possible only if the bank has the full confidence of its depositors and creditors.

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The confidence level of a bank's depositors, creditors, customers and other constituencies -- including market analysts and bank supervisors -- is thus the key to capital adequacy. Measuring confidence levels is elusive and still more art than science, but most analysts and interested observers agree that there are certain quantitative factors that influence confidence levels. One of these is a bank's earnings. If people perceive that a bank may be unable to earn money in the near and medium term, confidence can be substantially eroded.

Another important quantitative factor influencing confidence is the absolute level of equity and reserves -- primary capital. Primary capital acts as a cushion to absorb unforeseen and temporary losses and permits financial institutions time to make the necessary adjustments to return to profitability. If, however, it is widely perceived that the level of capital is inadequate to absorb actual or potential losses, confidence in the institution rapidly declines and the institution fails. Perceptions can thus be extremely important in this respect. For example, important bank constituencies influencing bank behavior generally perceive that a capital cushion in the range of 5 to 7 percent of total assets is adequate, assuming normal risk in asset portfolios, average earnings and growth patterns and reasonable liquidity. Standards and guidelines have been set in this range by the regulators, although the regulators also weigh other objective and subjective criteria in deciding whether capital should be higher or lower than the guideline.

I believe the capital guidelines currently in force have been reasonably effective in helping to assure enough bank capital to maintain a high level of confidence in the banking system. Simple capital to total asset ratios are the most popular and accepted ratios and serve their purpose well as guidelines. Reasonable exceptions have and should be made when appropriate.

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With better information increasingly available and considering the progress made in analytical techniques in the past few years, the agencies should consider moving away from simple capital guidelines and toward more sophisticated risk based capital ratios and guidelines. It has long been widely recognized and obvious that it takes less capital to support such assets as short term government securities with little or no depreciation than it does to support riskier loans and investments. It seems to me that the regulators, with industry input, should be able to come up with ways to assign efficient capital guidelines for each of the general classes of bank assets. Off balance sheet risk of various types should also be taken into account. Such a process will necessarily involve assigning arbitrary ratios which may not be appropriate for all financial institutions. Because of this and keeping in mind that assessing capital adequacy is basically a subjective exercise, the guidelines should be flexible enough to permit exceptions in appropriate circumstances. The guidelines should also be just that: guidelines, not rigid rules embedded in law.

-- Risk Based Deposit Insurance

It is easy to agree with the concept that deposit insurance premiums ought to be assessed based on the risk the financial institution poses to the federal deposit insurance funds. While nearly everyone agrees with the concept, no consensus exists as to how to do it fairly and objectively.

This is because it is very difficult, and perhaps impossible, given the current state of the art, to identify and measure accurately the real risk any given financial institution poses to the insurance fund. Any such scheme will therefore have to be somewhat arbitrary in methodology.

One possible solution might be to tie deposit insurance premiums to risk based capital guidelines. This assumes, of course, that the federal banking and insurance agencies are able to develop appropriate capital guidelines along the lines discussed above.

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Whether or not a risk based deposit insurance scheme is implemented, troubled financial institutions requiring special supervisory attention should be required to pay for the examination, supervision and administration costs incurred by the agencies, excess of that incurred in the normal course of examining and supervising non-troubled banks.

Concluding Comments

These hearings are designed to review a large number of supervisory and examination processes, including the deposit insurance system. I have touched on a significant number of the issues involved in this statement. I will be glad to answer any questions the Committee may have on the issues I have addressed or on other matters of interest to the Committee regarding bank examination and supervision and deposit insurance.

The CHAIRMAN. Mr. Ryan.
Mr. RYAN. I thank you.

STATEMENT OF JOHN E. RYAN, FINANCIAL CONSULTANT, ARKY, FREED, STEARNS, WATSON, GREER, WEAVER & HARRIS, P.A.

Mr. RYAN. Thank you, Mr. Chairman. Much has been written about the perceived shortcomings of the Nation's system for supervising financial institutions in light of the recent dramatic increases in the incidence of commercial bank and savings and loan failures and near failures. In the aftermath of these problems and with the prospect of perhaps more to come, it is wholly appropriate to question the efficacy of a system whose direct responsibility is to ensure the safety and soundness of our financial institutions.

To those of us who have dedicated years of service to the task, a fair and objective inquiry is most welcome and long overdue.

I would like to state at the outset, however, my strong opinion that the supervisory system, while a handy whipping boy, cannot and should not be expected to prevent all of the excesses underlying many of those failures and problems. The portfolios of our Nation's banks after all mirror general business conditions, practices, and expectations. The examiners cannot stand alone against the tide of or, for that matter, fail to be persuaded by such prevailing conventional views as: High rates of inflation are here to stay; farm land will always continue to increase in value; the smart way to operate a business is to maximize leverage and minimize taxes; the world's oil supply is dwindling and $60 per barrel crude is just around the corner; and countries can't go broke, therefore, lending to them is relatively riskless, et cetera, et cetera.

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If I may depart from my statement for just a moment, I think the fact that conventional wisdom is wrong again and again underlies some of the basic problems we have. Moreover, it is a mixed blessing that we can identify banks 3 years before they fail.

If we are able to identify banks 3 years before they fail or 2 years before they fail, the question is: Why wasn't that failure prevented?

Also, I take little comfort in the fact that the marketplace is disciplining—by bidding down the value of stocks—institutions that everybody knows to be risky.

If you look at the record, you will see that the marketplace was actually bidding up the value of those shares at the time when those institutions were aggressively pursuing the business that ultimately led them to the problems they have now.

My point is that problem identification is just one aspect of bank supervision. The second aspect is the prescription: what to do about the problems when they are found or, even more importantly, how to head them off early enough so they don't become severe? This is a very complex and difficult process, and I'll go back to my text, if I may.

Once the intelligence is gathered, the data analyzed and the examination results known, the real challenges begin. What to do about it?

The answers are relatively apparent when it is clear that an unsafe or unsound condition exists or that a practice being followed is unsafe or unsound. Furthermore, the steps that should have been taken in an institution that has failed are always apparent with the advantages of hindsight.

In the early stages, however, when strategies are being implemented, it is often not so clear, and the judgment of the supervisor and the bank manager may differ. Whose judgment should prevail? The judgment of the manager, who has been hired by the owners to run the bank? Or the judgment of the Federal bureaucrat?

In these situations, there are two choices for the supervisor. First, intervene with cease and desist or other appropriate sanctions and preempt the strategy, or, second, criticize the practice, ask the board of directors to review it and keep the institution under close surveillance. The tendency is to pursue the latter course, but the risk is that the bank will aggressively pursue the strategy until it is clearly unsafe or unsound, which may be too late.

What I have described is the dilemma of a supervisor and the hard choices he or she must make. Of course, they must possess the skills and know when to move and they are being paid to make these decisions. My personal feeling is that the agencies should probably move more forcefully sooner than they do. But this is a general comment and is clearly not applicable in all cases.

My point in describing that process is to note that this is an imprecise art. To know when to move and to move soon enough so that the problem doesn't become so severe that it's impossible to turn the institution around is very difficult. As long as we operate in a free economic environment with the managers of banks an-

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swering to their shareholders, judgments will be wrong. We will continue to have bank failures even though we improve marginally the supervisory effort; we improve capital positions of banks, and we have better market discipline.

For all of those reasons, because we will still continue to have bank failures, and many of them, it is important that nothing be done that would undermine the effectiveness of the Federal safety net. Discussions about changes in the deposit insurance coverage are useful and risk-based premiums and other devices might be helpful. But as a quid pro quo for further deregulation, or on the theory that it can't happen to me, some of the industry would be willing to accept a lesser degree of Federal protection that are now in place.

These individuals may be unwittingly pursuing their own corporate interest at the expense of stability of our financial system as a whole.

I thank you.

[The complete prepared statement follows:]

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Statement by

John E. Ryan

Financial Consultant

Arky, Freed, Stearns, Watson, Greer,
Weaver & Harris, P. A.

It is a distinct honor to appear before this Committee and testify on the important issues affecting the future of the U. S. financial system. As one who spent twenty-five years with the Federal Reserve regulating banks and bank holding companies, I have had considerable experience in this field and also hold some strong views on the issues before Congress. Having moved to the private sector recently as a bank and financial consultant, I find that my concern for the maintenance of a safe and sound banking system and a stable economic environment has not lessened and, indeed, may have intensified. Mr. Chairman, I am grateful to the Committee for the invitation which provides me with an opportunity to express my views and share my experience.

Much has been written about the perceived shortcomings of the nation's system for supervising financial institutions in light of the recent dramatic increases in the incidence of commercial bank and Savings and Loan failures and near failures. In the aftermath of these problems and with the prospect of perhaps more to come, it is wholly appropriate to question the efficacy of the system whose direct responsibility it is to ensure the safety and soundness

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of our financial institutions. To those of us who dedicated years of service to the task, a fair and objective inquiry is most welcome and long overdue.

I would like to state at the outset, however, my strong opinion that the supervisory system, while a handy "whipping boy", can not and should not be expected to prevent all of the excesses underlying many of those failures and problems. The portfolios of our nation's banks, after all, mirror general business conditions, practices and expectations. The examiners can not stand alone against the tide of or, for that matter, fail to be persuaded by such prevailing conventional views as: high rates of inflation are here to stay; farm land will always continue to increase in value; the smart way to operate a business is to maximize leverage and minimize taxes; the world's oil supply is dwindling and $60.00 per barrel crude is just around the corner; countries can not go broke, therefore, lending to them is relatively riskless; etc., etc.

It is also important to note that the supervisory system is influenced and, in fact, takes it direction from the prevailing ideological winds. These winds

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have unmistakenly been blowing away from Government intervention toward a so-called free market approach. When that free market approach doesn't work or, more correctly, works too well, the cry of where were the regulators, rings somewhat hollow. I for one am pleased to see what I believe to be a shift in that wind as these very hearings would seem to suggest and also to see a shift, albeit not universal, in general business attitudes reflecting the market's renewed emphasis on quality.

I will now turn to some of the specific topics mentioned in the Committee's invitation to testify. Although I did not have time to address every point, I will try to deal with those with which I worked most intimately.

Market Discipline

The disclosure issue and the role that market discipline plays in promoting a safe and sound banking system are very difficult and complex. Clearly, over the past decade the banking industry has moved toward much fuller disclosure without the adverse consequences that many feared. On the other hand, this fuller disclosure does not seem to have yet resulted in the positive effects that were predicted.

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That the market works as a disciplinarian is undeniable. But, does it work consistently over the long-term in a manner that promotes the safe and sound behavior essential to stability? Or is it a cause of instability? A review of some of the more conspicuous recent problem institutions reveals that the markets actually reinforced and rewarded extremely aggressive behavior by bidding up the value of the institutions' shares as they turned in remarkably high growth and earnings rates. Of course, the markets turned quickly the other way when it became apparent that the deposits had been invested in inferior quality assets. In these instances, the markets functioned as expected. But, it is precisely this type of boom and bust cycle that is unacceptable on a large scale from a public policy perspective because of the special and central role depositories play in our economy.

Bold new steps to encourage the market to exercise a greater degree of discipline over banks are being proposed by some. Recently, for example, the FDIC indicated it would disclose formal enforcement actions against banks ostensibly to encourage market discipline. Banker groups responded in horror, fearing that such disclosures would cause runs. It is

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interesting to note that the two may have been closer than they may have perceived since a bank run, after all, is market discipline in its ultimate form.

Of course, the markets play an important disciplinarian role and, as I mentioned, the signs today are that the markets as they relate to financial institutions are putting a premium on quality. But, they are not a substitute for effective supervision and regulation as long as public policy requires relative stability in our depository institutions. Striking the appropriate balance between the role of the market place and the need to maintain stability is the challenge. In the wake of recent bank and Savings & Loan crises which have highlighted public concern is not, in my opinion, a propitious time for bold experiments with the market place.

The Supervisory Process

The Committe's interest in how the supervisory process can be improved is a subject to which I have devoted considerable thought and have concluded that there are no quick fixes such as a key piece of legislative authority or some magic computer formula. Improvement will probably have to come from doing the job better and more effectively which means devoting

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more resources and making a larger commitment to it. Although interrelated and somewhat indivisible in practical application, it may be useful for discussion purposes to separate the process into two functional parts, fact-finding/analysis and corrective action.

The tools used by the regulatory agencies for fact-finding and analysis include on-site examinations, acquisition and screening of financial data and general intelligence gathering. Considerable debate can be generated among practitioners of the art of analyzing financial institutions about which of these tools is best, but my experience is that the process is most effective when all three, drawing on one another, are used adroitly. My bias, however, is for on-site examinations since they alone provide the opportunity for first-hand observation of the policies, procedures and safeguards in place in the financial institution. Unfortunately, of the three, the on-site examinations have probably suffered the most because of budgetary cutbacks and changes in emphasis and training for examiners occurring in substantial part because of those cutbacks.

With respect to changes in the techniques of conducting examinations, probably the most dramatic has been the increased extent to which examiners use

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and accept the financial institutions' own management information systems such as internal loan quality reviews. Because of the increased use of the banks' internal systems, far less independent qualitative analysis and physical verification of documents is being done by examiners. The result of this development, in my view, is that there is a lesser degree of sensitivity to the overall credit policies and lending practices of the institution making it less likely that unsound practices will be uncovered before serious loan problems become obvious.

I want to be very careful here because the differences I am referring to are subtle and are a matter of degree. Of course, examiners can't look at every loan; of course, examiners have to rely on internal information systems; and, of course, examiners test these systems for reliability before using them. My perception, however, is that a greater degree of independent credit analysis and verification of collateral and documents with an emphasis on the current risk taking strategy would improve performance.

The conduct of on-site examinations by competent personnel with adequate training and experience is, of course, an expensive exercise and efforts to make it more "cost-effective" have to be made. The fact

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is, however, that precisely at a time when our financial institutions are experiencing some of the most serious problems they've faced in the post-war period, on-site examinations are being cut back. The explanation for the reduction is that the emphasis has been shifted from examining well operated banks to examining problem institutions. The obvious question is -- how do they know? Although there are back-up tools to help identify problem institutions, none is fool proof.

One method used to help identify problem and potential problem institutions is the screening of financial information from regulatory reports and other sources. Assuming that the information reported is accurate, the use of computer models to analyze these data is a very effective way of identifying problem institutions and, to a considerably lesser extent in my view, predicting which institutions are headed for problems. This technique has been very helpful to the regulators in scheduling examinations and targeting scarce resources.

Computer-based analysis of regulatory reports does have shortcomings, however. Unless the institution reports something out of the ordinary such as phenomenal growth, declines in net income or unusual increases

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in the loan loss reserves, it is likely to go unnoticed. I doubt, for example, whether a computer-based system would identify at an early stage practices such as insider abuses and shifting of assets between institutions.

There are two implementational problems that I observed during my tenure that, if ameliorated, would increase the effectiveness of computer-based surveillance. The first is the timeliness of the data and the second is the inordinate delays encountered in any attempt to collect new data or to modify existing reports to take account of changing financial practices. With respect to timeliness, considerable improvement had been made by those responsible before I left the Federal Reserve and I assume that those efforts continue. As you must appreciate, the logistical problems with collecting data from thousands of banks and bank holding companies throughout the year are enormous. However, the delays encountered in efforts to modify reports were almost insurmountable in any reasonable time frame, although there may have been changes since my departure. The Paperwork Reduction Act and the internal procedures of the Agencies themselves made changing the reports a lengthy and

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time-consuming process. While burden and cost to the industry have to be considered, this process needs to be modified if it has not been done.

With respect to general intelligence gathering, the Federal Reserve, because of its unique role as a participant in the market, its payments system and Discount Window functions, and its strong regional presence through the Reserve Banks, possesses an excellent intelligence network. Moreover, at the Federal Reserve, periodic discussions with representatives of the banks and Savings & Loans concerning trends in banking and current conditions are held through the Federal Advisory Council and the Thrift Advisory Council, and the Reserve Banks and Board staff representatives have frequent meetings concerning problems and trends with individual bankers. The other Agencies also have their sources of information, and communication between the Agencies at the staff level was frequent and open when I was at the Federal Reserve and I assume that continues. On the whole, I would rate the intelligence gathering performance of the Agencies rather high.

Once the intelligence is gathered, the data analyzed and the examination results known, the real

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challenge begins. What to do about it? The answers are relatively apparent when it is clear that an unsafe or unsound condition exists or that a practice being followed is unsafe or unsound. Furthermore, the steps that should have been taken in an institution that has failed are apparent with the advantages of hindsight.

However, in the early stages when strategies are being implemented, it is often not so clear and the judgment of the supervisor and the bank manager may differ. Whose judgment should prevail? The judgment of the manager, who has been hired by the owners to run the bank, or the judgment of the Federal bureaucrat?

In these situations, there are two choices for the supervisor. One, intervene with cease and desist or other appropriate sanctions and preempt the strategy, or, two, criticize the practice, ask the Board of Directors to review it, and keep the institution under close surveillance. The tendency is to pursue the latter course, but the risk is that the bank will aggressively pursue the strategy until it is clearly unsafe and unsound which may be too late.

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What I have described is the dilemma of a supervisor and the hard choices he or she must make. Of course, they should possess the skills to know when to move and are being paid to make those decisions. My personal feeling is that the Agencies should probably move more forcefully sooner than they do, but this is a general comment and is clearly not applicable in all cases.

If you would indulge me, just a word about resources. I know from personal associations over the years that all the Agencies have extremely competent and dedicated staffs and examiners. Although I don't have hard data, I know from my experience, and that of my colleagues in the other Agencies, over the past several years resources have not been permitted to grow commensurate with the increased size and complexity of the task. In some cases, resources have actually been reduced. As I mentioned, cutbacks in examinations have, in many cases, had to be made because of lack of resources. If the Committee significantly upgrades this process, then it will need to look very carefully at increasing the budgetary commitment to it.

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Capital Adequacy

A major accomplishment in promoting bank soundness is the dramatic improvement in the capital positons of U.S. banks, particularly the largest banks. Speaking from the perspective of one who labored both unsuccessfully at the task of trying to encourage banks to improve their capital positions during the 1970's and much more successfully in the 1980's, the improvement is nothing short of remarkable. With the help of a reduced rate of inflation, the improvement was accomplished, in my view, because the regulators laid down clear and concise standards and the Congress backed them up with necessary statutory authority.

Now the institutions and the regulators are engaged in a debate over the methodology employed in setting the standard. Presently, the standard is calculated as a ratio of capital to total assets as opposed to a requirement that distinguishes between assets based on risk. There seems to be considerable support for the risk-based requirement and it does seem appropriate that those institutions with a higher risk profile be required to maintain higher capital than those with lower risk. Under the present standard, this distinction is not specifically made, although

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it is a minimum for all banks to be adjusted upward for those with greater risks. My only reservation about moving to a risk-based requirement -- which was used in the 1970's -- is the loss of simplicity and the inability to quantify with any degree of precision the prospective risk in various types of assets.

The Federal Safety Net

Even with improved supervision, constructive market discipline and strong capital positions, financial institutions will continue to experience problems and fail. Hopefully, not as many as would otherwise, but much depends on the state of the U. S. and world economies. If the Federal safety net does not protect our money markets, payment systems and the public from the devastating effect of these failures, the risk is that dislocations will occur and general stability will be threatened.

The proposals being made concerning changes in the deposit insurance system need to be viewed in this context. Nothing should be done that would reduce the coverage of the Federal safety net. The FDIC should not be prevented from rescuing large

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institutions or arranging mergers that make all creditors -- including uninsured creditors -- whole. In fact, Congress should make it clear that in insolvencies its preference is for assisted mergers over liquidations unless there is some overriding reason to the contrary.

On the theory that it can't happen to me and/or as a quid pro quo for further deregulation, access to new and different markets, and the right to engage in a broader range of activities, a growing number within the industry have indicated a willingness to accept reductions and major modifications in the Federal protections extended to depositories. But what these individuals may unwittingly be doing is pursuing their corporate interests at the expense of the stability of the financial system as a whole.

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The CHAIRMAN. Mr. Brooks, your time has finally come to be on that side of the witness table.

STATEMENT OF THOMAS A. BROOKS, PARTNER, DICKSTEIN, SHAPIRO & MORIN

Mr. BROOKS. Thank you very much, Mr. Chairman. I know it is a rarity for a Washington lawyer, given the opportunity, not to hear his voice reverberate throughout these hallowed halls, but in the interest of time, I will forego any oral statement I planned to make today, as my complete statement will appear in the record in any event. Therefore, if you have any questions you might want to ask this panel, please proceed.

The CHAIRMAN. Gee, you're never that brief when you're on the stand. [Laughter.]

I know. Having been general counsel to this committee and having experienced the other side of the table, I'm very sensitive to this.

[The complete prepared statement follows:]

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TESTIMONY OF THOMAS A. BROOKS
PARTNER
DICKSTEIN, SHAPIRO & MORIN

Mr. Chairman and members of the Committee, my name is Thomas Brooks and I am happy to appear before the Senate Banking Committee on the very topical and important issue of deposit insurance reform. Currently, I am a Partner in the Washington, D.C. based law firm of Dickstein, Shapiro & Morin. Prior to joining the firm, from 1981-1984, I had the privilege and challenge of being General Counsel of the Federal Deposit Insurance Corporation (FDIC).

The position was a challenge because beginning in 1981, the FDIC and other banking agencies experienced unprecedented growth in the number of problem banks, the number of enforcement actions it initiated, and the number of bank failures that occurred. The trend has not been abated. Because of the increased number of failing and failed institutions and projections of more of the same in the future, questions have arisen as to whether the existing structure of our deposit insurance system is adequate to deal with potential problems. In partial response to these questions, in the Garn-St Germain Depository Institutions Act of 1982, Congress mandated that the FDIC, the Federal Home Loan Bank Board (FHLBB), and the National Credit Union Administration Board (NCUA) each conducts its own study of the adequacy of the deposit insurance system and recommend proposed changes, if necessary. These studies were completed in the spring of 1983.

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As a result of continuing problems in the banking industry, highlighted by the Continental Illinois matter in 1984, the Administration, under the auspices of the Working Group of the Cabinet Council of Economic Affairs, began work on a study of the deposit insurance system. The study was completed in January of this year, and contains recommendations for change in the current deposit insurance system.

Because of the importance of this issue, last month the Morin Center for Banking Law Studies, an institute of the Boston University Law School, sponsored a one day conference on deposit insurance reform. Each year the Morin Center convenes a conference in an academic environment to enable leaders and decision makers in the financial services industry to discuss issues that are highly topical. Among others, this year the speakers included Congressman Doug Barnard, FHLBB Chairman Ed Gray, Acting Comptroller of the Currency Joe Selby, FDIC Director Irvine Sprague and New York Stock Exchange Chairman John Phelan. I served as moderator for this year's conference, and can tell you that, among the speakers, the perceptions of the problem were as varied as the proposed solutions. If there were a consensus on any one issue, however, it was that greater supervisory efforts must be made by state and federal regulators in order to assure safety and soundness in our financial institutions.

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In discussing deposit insurance reform, the initial question appears to be whether or not there is a problem in our existing system that needs to be corrected. First of all, what do we mean by "deposit insurance system"? How does it relate to new powers, regulatory reform, and safety and soundness? Fifty years ago, we established a system which had two primary purposes: 1) to provide a safe place for the worker, the farmer, and the everyday citizen to keep their funds, and 2) to create nationwide confidence in our financial system by preventing runs on financial institutions which resulted in insolvencies. Are these purposes still valid, or are they outdated? If the latter, what should be the purposes of a contemporary deposit insurance system? Has banking changed so significantly, not only in the services offered but in how such services are delivered to the depositor and customer, that the basis for the existing system is outdated? Do we care more about protecting all depositors versus just the small depositor? Are we treating large bank failures differently from small ones? Should we only insure certain types of deposits and not others? These are just some of the fundamental questions that are beginning to be asked.

Mr. Chairman, there is but one point I would like to make today, one that is both obvious and simple: we would not be here today if we did not have almost 1,000 banks on the problem bank list, a projection of a record 100 plus failures this year, and a

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thrift industry so debilitated that no one has been able to suggest any reasonable short term solution.

If our financial institutions were in better shape, we would not be having this debate. Therefore, we must ask ourselves whether or not our banks and thrifts will continue to be in such poor shape over the next several years, or whether this current cycle is an aberration. In my opinion, we shall continue to have a higher than historical number of problems and failures in the years ahead, although not necessarily the rate we see today. In addition to the traditional reasons for bank problems and failures (such as criminal activity, negligence, incompetence and, to a degree, economic conditions), routine failures in the future will reflect the impact of competition on marginal operators.

Are bank failures bad? Well, obviously they are not good, but as long as they can be handled with minimum economic disruptions and do not threaten the stability of our financial system, I think the public has come to accept as a matter of course the failure of federally insured banks. Recently, seven banks closed in one week, more than we have had over a comparable period in many years indeed, and this event barely made the news.

We have become conditioned to accept bank failures because, as a result of deposit insurance, most of the public has

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been relatively unaffected by such failures. What can be done to minimize the number of problem banks and the number of failures? Is there a methodology available to help us to better predict problems and failures in order to minimize potential losses? Although on-going studies offer suggestions, certain problems of this nature are hard to gauge: for example, it is virtually impossible to predict intentional criminal conduct which results in bank insolvencies. Equally difficult to anticipate are the sudden credit reversals or surprises of particular significance to smaller institutions.

Examination and Supervision

That there is a growing staffing problem in the bank examination force, recently the subject of a Wall Street Journal article. The more experienced an examiner becomes, the more valuable he or she becomes in the private sector. In addition to the attractions of greater monetary reward outside of government, there are the difficulties faced by examiners who are often required to work long hours or be away from home for weeks, and in some cases, months. Additionally, as banks engage in new activities and become more sophisticated in their operations, conventional training and education courses may be inadequate. These problems must be addressed. In short, we need more experienced and better trained examiners, we need to refine our

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examination techniques, and we need to develop incentives for our examiners to remain with the agencies.

Disclosure

In order to minimize the impact of problem banks, we must consider what changes, if any, there should be in our handling of information about financial institutions. What should be disclosed, in what format, by what kind of institution, and to whom? These are questions that have been hotly debated. I am one who thinks that more disclosure will help all institutions. At the very least, both banks and thrifts periodically should disclose basic current financial information in a common format in local newspapers. More detailed information about an institution, which regulators should require them to maintain, ought to be available to the public on request. Additionally, serious consideration should be given to disclosing certain information yielded during the examination of the institution.

While it might be difficult immediately to require all banks and thrifts to keep their books according to the same accounting standards, it is highly desirable that efforts be started now to achieve uniformity in the application of common accounting principles to financial institutions. A depositor who wants to ascertain an institution's financial strength prior to dealing with it, should be able to look at its financial

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statement and know that the statement has been prepared in the same manner and according to the same principles as that of any other institution.

Enforcement

Another method to minimize the risk to the deposit insurance funds is prompt enforcement action where warranted. One of the regulators' strongest controls over an institution is the threat of an enforcement action, be it an informal agreement or the most drastic termination of insurance proceeding. The usefulness of this tool is further enhanced if the bank knows that the final order or agreement will be made public. Banking is an industry based on trust and confidence, and if the public is aware that an institution is having some problems, it will more closely scrutinize the institution before dealing with it.

The practical problem with enforcement actions is that they are labor intensive. While most enforcement actions are the result of consent agreements, those that are challenged through the administrative and judicial process can be very time consuming and expensive for the agency and the bank. Even those that are resolved on a consent basis often are the result of extensive negotiations. The FDIC proposes to disclose final enforcement orders starting in January 1986. Some have argued that such disclosure of final consent orders will result in more litigation

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by the banks and thrifts. If so, agencies will need additional experienced personnel to deal with these actions.

While general enforcement guidelines may be useful, there is a strong argument that agencies should retain as much discretion as possible in this area. For example, while a particular institution's earnings might be found to be weak, its other characteristics (including capital, liquidity, and management) might be strong. All these factors must be balanced prior to making a decision as to what action, if any, should be initiated.

Risk Related Premiums

There has been much discussion over the past few years about having banks pay deposit insurance premiums based on some measure of risk of the institution's failure. It has been argued that if an institution engages in some new "riskier" activity beyond that in which it traditionally has been involved, the institution should pay an increased deposit insurance premium. While risk related premiums may sound like a good idea, they are, in my opinion, of limited value.

One proposal for a risk related premium would have an institution classified "risky" forfeit any rebate that it might normally expect to receive. For example, if an institution had $100 million in deposits, it could expect to be assessed about

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$80,000. Historically, while an FDIC-insured bank is assessed a premium of 1/12 of 1% of deposits, its rebate would cut the premium approximately by half. Were this institution denied a rebate of $40,000, the financial penalty would not be a sufficient deterrent. In all probability, public disclosure that it was a "risky" bank would have more of an effect than the $40,000 penalty. Admittedly, however, it is not a simple matter to develop objective criteria by which the relative risk of all institutions can be measured. Not only must the criteria be fair and uniformly applied, but they must be applied to institutions whose assets are evaluated by a common standard, and whose balance sheets are presented using the same accounting principles.

Another proposal suggests that if institutions engage in riskier activities, there should be additional capital requirements or other regulatory measures should be taken in order to guarantee safety and soundness. This assumes that certain activities are inherently unsafe or unsound, a concept which I reject. I am unconvinced that securities brokerage, real estate development, or insurance underwriting is more or less risky than commercial lending. The key is not the activity itself, but the manner in which the activity is conducted. If the chartering authority allows an institution to engage in new activities, then that authority and the insurer have an obligation, through regulations and examinations, to make sure the activity is conducted in a manner which does not jeopardize safety and soundness. The

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important question regarding new activities of banks and thrifts is not so much one of safety and soundness as one of competitive equity. Is it fair for a bank to underwrite insurance, for example, where the bank is backed by the safety net of federal deposit insurance, while an insurance company does not enjoy any of the benefits of such deposit insurance system?

Foreign Deposits and Off-Balance Sheet Items

Another issue that should be considered in discussing deposit insurance reform is the potential impact of off-balance sheet items such as stand-by letters of credit and the exclusion of foreign deposits in the assessment base. Clearly, if a U.S. bank fails and if it has overseas-based deposits, those deposits will have to be dealt with in the resolution of the problem. Currently, the law excludes deposits payable outside the U.S. from the assessment base. If the deposit insurance fund is subject to risk of loss as a result of dealing with these foreign deposits, a strong argument can be made for assessing them.

Additionally, off-balance sheet items such as stand-by letters of credit have recently been determined to be deposits by some U.S. courts. If these rulings prevail, they will pose an additional risk of loss to the deposit insurance funds for which no premiums have been paid. In dealing with any modifications to our deposit insurance system, we must consider these off-balance

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sheet items which could have a very significant impact on our deposit insurance funds.

Bank Closings

An issue closely connected to any discussion of deposit insurance reform is how banks are treated when they are found to be insolvent or close to insolvency. Should they be closed or should they be "bailed out" with federal financial assistance prior to closing? If closed, how should the bank be treated: pay-off, modified pay-off, purchase and assumption, or some other method?

The law currently allows the FDIC, for example, to take a variety of steps to prevent the closing of an insured bank. Its power has been used sparingly, however, because for the most part, it results in protecting shareholders and subordinated debt holders from risk of loss, something Congress did not intend the deposit insurance fund to do. When a bank is closed, the law allows the FDIC to arrange for a variety of transactions, such as a purchase and assumption or a modified pay-off, if such action is less costly to the FDIC than a straight pay-off. This "cost test" may be waived, however, if FDIC determines that the banking services involved are essential to the community.

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For the most part, FDIC has arranged purchase and assumption transactions because they have proven to be cheaper and have provided minimum disruptions in banking services to depositors and customers. Pay-offs have occurred normally when no buyer has been found for the failed bank, or the contingent liabilities of the failed bank are so great that the cost of liquidating the bank could be less than any other alternative. Purchase and assumption transactions have had the unintended result of providing 100% deposit insurance coverage to all depositors, including those with deposits in excess of $100,000. Additionally, in dealing with very large banks, purchase and assumption transactions have been thought to be the only alternative in view of the economic dislocations resulting from a pay-off, and the many administrative obstacles involved. There is the glaring inequity, however, that small banks might or might not be subject to a pay-off while large banks would never be so subject.

This situation suggests that we must explore alternatives to the purchase and assumption transaction. The modified pay-off is an alternative that has been the subject of much discussion recently. If used for all bank failures, it would provide for protection of all depositors with $100,000 or less on deposit, it would not provide 100% deposit insurance for depositors with over $100,000 on deposit, and it would embody such characteristics of a purchase and assumption transaction that most customers and depositors would suffer minimum disruptions. It remains to be

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seen, however, if this approach can in fact overcome the severe administrative obstacles so it could be made applicable to a large bank failure.

A system that relies exclusively with one method of dealing with a failing or failed bank significantly reduces the regulator's flexibility in dealing with unanticipated or novel problems. Each failing bank has different characteristics that might affect a regulator's approach prior to a closing. There must be some flexibility in dealing with these unexpected, novel situations, such as delaying the closing of one bank so that it might be "packaged" with another bank that is expected to close in the near future. Technical and substantive changes in the law that could be made to give the regulators and insurers greater latitude in this area.

Other Proposals

It is difficult to review deposit insurance in a vacuum without also considering other major legislative proposals, such as new powers for banks and regulatory reform. The Committee has already had extensive hearings on the subject of new powers, and I would hope that the proposals embodied in the Bush Task Group Report would get serious consideration in the near future. There is also the question of merging the FSLIC and the FDIC. This subject has aroused the passions of the executives of both banks

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and thrifts. I will only comment that, if banks and thrifts are allowed to do similar activities, if their loans are evaluated using similar criteria, and if the same accounting standards are applied to determine the financial condition of the institutions, a much stronger case can be made for merging the two funds.

Mr. Chairman, this concludes my statement. I shall be happy to answer any questions you might have.

The CHAIRMAN. Thank you, gentlemen.

Mr. Cates, your comments are very direct. I had no trouble understanding your position. Like on the risk-adjusted deposit insurance, I am deeply opposed to risk-related premiums for three reasons:

First, I don't believe the FDIC has demonstrated risk-assessment methodology that would be reasonably fair. I don't necessarily disagree with that. The thing that disturbs me about your making such a strong statement and then going on to say, "The leakage of this simple, important information would stigmatize the banks in the eyes of the public."

I'm a little puzzled with such a direct statement, "That the clumsy and drastic step is not necessary."

Well, we have got a problem out there and you, of all people, ought to know that. You're a professional bank analyst. We've got a problem. The world is changing. We hear comments about whether we ought to have further deregulation or not.

DEPOSIT INSURANCE SYSTEM IS CHANGING

Well, let me put it in the same kind of language which you're using. That's kind of a stupid comment because deregulation is occurring. It doesn't make a bit of difference what this committee does: whether we ever pass a bill or not. The marketplace is changing and the real world is changing, and deregulation is occurring at an ever-increasing pace. The deposit insurance system is, or should be, changing. You've got a dramatically different marketplace out there.

You get paid for your numbers. And guys at FDIC don't, but none of them are very active. Both you and Mr. Keefe can be very, very critical of the regulators and I can too. I share a lot of your opinion.

But your track records over the years isn't very much better. Mr. Keefe came in here in 1981 and scared me as the new chairman of this committee by saying that we were not going to have a thrift institution left by the end of 1982.

Mr. KEEFE. Well——

The CHAIRMAN. And he was just as dogmatic then as he is today.

Mr. KEEFE. Well, if you look at their net worth, and you weren't having them artificially propped up by the Federal Home Loan

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Bank, you wouldn't, and you've got savings banks in New York City that are bankrupt. The Bowery Savings Bank is running on FDIC money. I was right. The Bowery is bankrupt. It went through the entire network, was advanced over $100 million by the FDIC and it's run through more than half of that.

The CHAIRMAN. My point is that none of you are very good at predictions. I'm not on any side of this, I'm just saying you can be as self-righteous as you want to be and condemn the regulators, or so on, but from my position, all of you are very good at making predictions and not very good at them coming true, much better than the economists.

Well, that's neither here nor there, but to get back to my point, Mr. Cates, you say it's difficult. Well, you know, I would never have accomplished much of anything in my life if I gave up because something looked difficult. You're condemning it before we have even examined it.

I don't know at this point whether we can come up with an adequate risk assessment, whether it is feasible to come up with risk-related premiums. But you're condemning them before we have really looked into it. Why?

I never would have been a U.S. Senator if I had listened to everybody who told me I couldn't win in 1974 because of Tricky Dicky and Watergate. I never would have flown in space if I had listened to all the critics who said you'll never get to go.

Now I'm being told don't even consider risk-related premiums; it's stupid, you're deeply opposed; we can't do it; it's too difficult, too much disclosure. Now, why?

If a man of your professional ability isn't willing to let the testimony flow over the next few months and make some decisions based on facts. You're condemning it before we even take a look. You may be right, is my point. I don't know.

Mr. CATES. Would you like me to answer your question? [Laughter.]

The CHAIRMAN. Yes; I have listened to 3 hours of witnesses. I'm entitled to speak for a minute or two.

Mr. CATES. Senator, I am not sure that I said that the risk adjusted deposit insurance would be difficult.

RESULTS OF HIGH-RISK STATUS

What I said is that the FDIC's documented approach to it is so oversimplified that many banks that are not deserving of high-risk status are going to be classified as high risk and many that are deserving of high-risk status are not going to be so classified, and this error factor which I predict will occur because of the oversimplified ratio system that they plan to use. The system will be unfair to banks because of the public disclosure of those insurance ratings.

What I proposed was that the ratio system or the risk assessment scheme of the FDIC simply be tested against known systems of failure prediction or risk assessment, systems that are known to work pretty well. Apparently, the CAMEL system is working pretty well today. Our rating system is working pretty well. So is Harry Keefe's. These offer a benchmark against which to test a risk adjustment system for fairness.

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The CHAIRMAN. Well, you go on to say, "Even if the risk ratings were reliable, then you get into leakage of simple and important information that would stigmatize banks."

So you are saying, OK, even if we can do it, 90 percent or even perfectly, what I hear you saying is don't do it because it is going to get out. Well, the trouble list gets out now. The bad banking institutions get out now. We have runs in Ohio and Maryland and every place else.

So what is the difference whether you have got a risk-related premium that gets out and somebody says, "Hey, that institution is paying more premiums," or finding out they are in trouble because of bad loans here or there? What is the difference?

Mr. CATES. The CAMEL system is based on a great deal of judgment, and that is the basis for the regulators problem list.

The CHAIRMAN. I am not talking about the CAMEL system. I am talking about even if you had a system that you wrote and you decided it was great, accurate, and everything else. You are telling me that that information would leak. Those who are not rated well and had to pay higher premiums, that would stigmatize them.

But isn't it true that information on institutions that are having problems gets out now? That is my question. What is the difference?

Mr. CATES. The information on problem institutions, to the extent it gets out, is because somebody is interpreting their financial statements, whether it is Harry Keefe or ourselves, and we are private parties, we are entitled to our opinions. People can disagree with us. But when an agency of the Federal Government establishes a very simple risk classification of average and above average risk, I believe that such public disclosure, the impact of that disclosure, will stigmatize good banks and possibly put some weaker banks that are capable of recovery over the brink.

The CHAIRMAN. I understand. I am not talking about the present system. I am talking about through this process if we can come up with a system.

But you have gone on to say that even if it is reliable disclosure.

Mr. CATES. Even if it is reasonably reliable, it can never be totally reliable.

You will stigmatize, perhaps permanently, perfectly good banks in competitive situations, and you will push weaker banks with a capability of recovery over the brink into failure by causing uninsured depositors, on the basis of our Government's insurance risk ratings, to fail.

The CHAIRMAN. No, we are not talking about Government disclosure. We are talking about leaks, and you still haven't answered my question: What about adverse information that leaks now? Why is a higher premium going to cause more stigmatization than other bad information?

Mr. CATES. The difference is in the complexity of the information. The information that leaks today is difficult to interpret. People can have different opinions, but the leakage of the FDIC insurance classification is about as plain as a barn door. No one is going to mistake the significance of that.

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ISSUE OF FAIRNESS

The CHAIRMAN. To either one of you, either Mr. Keefe or Mr. Cates: What about just the fundamental issue of fairness? Why should the conservative, well-run bank that you would rate highly and report to your clients, and so on, as being good and solid, subsidize the poorly managed? Why should the go-go operators and those that are out making poor risk assessments in their loans, and so on, be subsidized by that well-run community bank?

I am not talking about the big boys. I am talking about the ones that serves the communities in my State.

Why should they subsidize the ones that are involved in risky activities?

Mr. KEEFE. Well, Senator, I think that is easy to say in theory, and I think what David and I are saying is that we have ratings. OK.

The ratings of my firm are not published, deliberately so, because we find they are misinterpreted. We do not publish them anywhere. We supply them to our clients. We send out a rating. We have lowered a rating of a bank from C to C/D, to D. We send them a letter, talk to them on the phone, and explain.

Let me give you a simplistic reason for the danger that Dave and I both see.

We dropped the rating on Michigan National Bank from a C to a D. Somebody leaked that to a reporter of the New York Times working out of Washington. He called me, and he said, "Does that indicate that Michigan National is going to go into bankruptcy?"

We lowered that rating because Michigan National had a high involvement in Penn Square, and they had a chairman we thought was a little flaky. We told that to our clients. We were able to explain that both verbally and in written material.

I begged the New York Times not to put that out because it would be misinterpreted. They ran a piece in the New York Times, Dateline Washington, "Keefe, Bruyette & Woods had dropped the rating of Michigan National from C to D. That is the same level they had on Penn Square before Penn Square went bankrupt."

The implication is it was on its way to bankruptcy. It was so far removed from the truth, we told our clients the next move on Michigan National would be up and not down.

The stock got hammered in the market; the company lost access to the CD market because it was a simplistic rating, without explanation, leaked in the media.

It frightens me, and it needs voluminous—I mean, we give our clients voluminous backup reasons as to why we have done this, and we are dealing with a very sophisticated cash management clientele. We are not dealing with the uninitiated public or some stringer writing for the New York Times or Dow Jones.

And I have had some of our clients—we have a contract that says they can't release the rating. Somehow or other it gets into the Dow Jones or one of the wire services, and it is always misinterpreted by the marketplace.

We lowered the rating on one of the money center banks, and the thing hit the Dow Jones wire, and they took 10 percent of the

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money center bank, boom, just like that, in the marketplace. We were buying them.

And so it is grossly misinterpreted, and that is the problem that bothers us because we have worked on this, and I think we are all learning.

Penn Square, we had a D. It should have been an E. But the Government agencies had a 3, which is equivalent of our C, so we were better than they were, but we weren't right, and we analyzed the data after the fact and the data was there. The information was there for Keefe, Bruyette & Woods, the FDIC. It was there for Continental Illinois to see.

So we modified our technique, and Professor Senchak is working out some new questions we put to our computer, and we have turned up some other banks with new techniques. We are dealing with a very different banking system than we had when I started 30 or 40 years ago. We didn't have this type of liability sector. You didn't have the farm loans. And we are learning to cope with it, and we will be better. We are not perfect.

The CHAIRMAN. Mr. Brooks.

FRESH LOOK AT DISCLOSURE ISSUE

Mr. BROOKS. Mr. Chairman, I think what we have just heard is endemic to the problem. I think we have to completely relook at the whole issue of disclosure. I think we have to—if the Federal Government is backing these financial institutions with Federal deposit insurance, and I am going to deal with these institutions, as a customer, then I want to know what condition those institutions are in before I deal with them.

Therefore I have to have the information I need so that I can make an intelligent choice about them, whether they have bad loans or good loans, what their capital is, et cetera, and that information is not available to the public.

I think in the past we have dealt in a very secretive nature with the financial institutions and their conditions, and I think we completely underestimate, perhaps, the ability of the press to properly report the condition of the institution. Such reporting would take into consideration any explanations by the people who are giving out that information as to what financial condition the institution is in, be it a Keefe, Bruyette, or a Cates, or an FDIC, or a Fed, or whoever it might be.

I just cannot believe that we cannot come forth with a lot more information about these institutions, their true financial condition, to the best degree we can measure it, which is not perfect by any means no matter who is measuring it, but, if anything, would be better than what we have today.

And I think that when you are looking at the whole issue of deposit insurance reform, we have to think new thoughts and not be bound by the past regarding how much disclosure we are going to have about Government-produced examination reports, about private sector reports, and about the information that we might require these institutions to report to the public themselves.

I don't know why insured financial institutions don't come out with monthly financial statements in the local newspapers. It is in-

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credible that there is a significant lack of information we have about these institutions, especially with the Federal Government backing these institutions with deposit insurance. It just doesn't make a lot of sense.

The CHAIRMAN. Well, maybe we end up with more problems of confidence because of uncertainty rather than knowing what the facts are and what you can deal with.

I have got a severe time problem. Senator Proxmire is going to take over for me, but I did want to say before I leave, particularly to Mr. Cates and Mr. Keefe, I have been deliberately hard on you trying to elicit answers because in my 10 years in this body I have seen too many series of hearings where we discuss problems and the end result is no change. Everything goes on as usual year after year, and I do believe there needs to be changes in the deposit insurance system, and as I said, I don't know exactly what those changes should be.

I am seeking information. I don't have preconceived ideas, but I hope we don't end up with just "This isn't reliable," "I don't like that," or something else. So I am trying to elicit positive suggestions of how we can change so that we just don't hold a series of hearings once again and everybody says, "Oh, that was nice, we had a lot of testimony, but nothing happened after it was over."

And that is why I pressed you very hard, Mr. Cates, and when you say, well, you don't like it, and so on, it doesn't work, well, let's find that out. That is why I am pressing you hard, to say, OK, just don't condemn it at the outside. Maybe 6 weeks from now, a couple of months from now I will say he was right, we shouldn't do it. I don't know.

So don't take my comments personally. I am going to try and elicit from all witnesses some "OK, I don't like this, but we can do this," but let's not be unwilling to take a look at it so that we just don't go through an exercise in producing another committee record that sits and draws dust.

I don't want to preside over a failure in the economic system or the financial system of this country and have listened to a lot of rhetoric back and forth from both sides of the table, but no action.

So I thank you very much for your willingness to testify. I apologize for having to leave, and I appreciate Senator Proxmire's taking over. He has had vast experience as chairman, and so I know the committee is in good hands.

Senator PROXMIRE [presiding]. Thank you, Mr. Chairman.

Mr. Cates, you claim that your rating system does a much better job than the regulatory agencies predicting bank failures. It has been suggested that your system may also finger a large number of banks that don't fail.

What is your record on this score? Of all the banks that you rate, 4 or 5, how many fail and how many don't?

CATE'S SYSTEM

Mr. CATES. A very small percentage. Five is our poorest rating.

Senator PROXMIRE. A very small percentage?

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Mr. CATES. Sure. We will put probably 10 to 12 percent of all the banks we rate into our 5 category, and the failure rate is well under 1 percent of all banks.

Senator PROXMIRE. Last year, it was one-half of 1 percent and it was the worst year in 50 years. Now, 79 banks have failed, 15,000 commercial banks in the country, so that's one-half of 1 percent.

So my question is, if you put such a large number in that 5 category and the overwhelming majority don't fail——

Mr. CATES. That's called type 2 error. Type 1 error is if you don't put the banks that later fail into that category. So we have a low type 1 error and we have a high type 2 error. The purpose of our rating system is to evaluate risk in banks, I define our 5 category as the banks least able to withstand a shock.

Senator PROXMIRE. What would you think of having a 6 or 7 category?

Mr. CATES. Well, if someone asked us to refine our system toward failure prediction rather than risk analysis, I think we'd do a lot better job. I outlined or described in my written testimony a particular California bank, the San Capistrano National Bank.

Senator PROXMIRE. Isn't that kind of like predicting every team in the American League East is going to win the pennant? You will be right one time out of seven every year.

Mr. CATES. I have to pick one. I could pick any number. I could have picked Golden Pacific, a much more recent failure.

Senator PROXMIRE. Let me get on another subject.

If the FDIC risk-premium categories were made available to the public, wouldn't there be an incentive for some of your customers to stop buying your service and rely instead on the FDIC-risk categories? Isn't that the real danger you're worried about?

Mr. CATES. We have so many lines of business, Senator, that I'd be happy to drop one of them and emphasize another. I mean, there are many ways for Mr. Keefe and myself to make a very constructive dollar in bank analysis.

Senator PROXMIRE. I have great faith and I think this is an excellent panel. All five of you gentlemen are obviously extremely able, and I don't mean to criticize you at all, but it does seem there's a conflict of interest on this particular issue. If the FDIC made the risk categories public, wouldn't that to some extent lessen the attractiveness of what you sell to your clients?

Mr. CATES. I don't think so, Senator, because we would go into a much more profitable line of work.

Senator PROXMIRE. Why don't you do that?

Mr. CATES. It's helping banks that were stigmatized by erroneous FDIC ratings to show that, in fact—[Laughter.]

Senator PROXMIRE. Well, Mr. Cates, we'd like to help you, so maybe we ought to do that so we can help you prosper even more. [Laughter.]

Let me ask you one other question. On page 13 of your statement, you say, "Bank capital is essentially irrelevant in determining the cause of bank failure."

You also say that, "If we are to impose minimum capital ratios, they should be measured against risk assets rather than total assets."

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At the same time, your rating service reports total capital assets to ratio and capital is essentially irrelevant. Why do you report it to your customers? Why do you focus on capital total assets that you argue is not a realistic measure?

ABOUT 70 DIFFERENT RATIOS TO CHECK BANKS

Mr. CATES. It's just another way of kicking the tires when you're looking at the used car. We have about 70 ratios and we interrelate these ratios in all kinds of ways.

Senator PROXMIRE. So it's not really totally irrelevant. You report that because it's of some value, I presume.

Mr. CATES. It's of great public interest. We would be remiss if we didn't report——

Senator PROXMIRE. Is it just interest or of some value to an investor in determining—or depositor determining where to put his funds?

Mr. CATES. It may be. I never take any one ratio as meaning anything at all. It's only in the context of 50 or 60 that I begin to——

Senator PROXMIRE. Let me take a specific instance. In 1963, the Continental Bank had a capital ratio of about 10 percent. By 1983 or 1984, they had a ratio of around 4. If they had had that 1963 capital ratio, would they have failed?

Mr. KEEFE. Yes.

Senator PROXMIRE. I didn't ask you, Mr. Keefe. [Laughter.]

I'll come to you in a minute.

Mr. CATES. If Continental in 1984 had a 10-percent capital ratio, and so did every other bank, then the crisis of Continental——

Senator PROXMIRE. That wasn't my question, if they had had it in 1985. Not every other bank. If Continental had had it, would they have failed?

Mr. CATES. If other banks were at a level of 5.5 percent and Continental was at 10 percent, I think that would have postponed the crisis of the bank. But I don't think it would have forestalled it, because of the illiquidity of that bank and the other things that were wrong with that bank.

Senator PROXMIRE. Well, it obviously would have made a difference and, as you say, would have postponed it.

Now, Mr. Keefe, you say they would have failed?

Mr. KEEFE. Well, if Continental's problem—and we haven't seen in our studies any correlation between the amount of capital and the failure of the bank. It's the lending problem. That's why I'm talking for greater disclosure in the lending portfolio. I think that's much more relevant to me as an analyst of banks if I have a greater disclosure breakdown by industry to loan concentration. That's sort of where the problems come in other than fraud.

But, Continental's problem was that it was a $45 billion bank; it has $2 billion in deposits. That's all. Two billion dollars. And $2 billion in capital funds and 41 billion dollars' worth of purchased money that had an average maturity of 60 days and in retrospect it was an insane composition of the liability portfolio, and all you needed to do was to take one thing and this money ran out so fast.

And we did not think Continental was a problem. We had our team visit them just before that. We told our customers we had it

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rated at C/D. But once the word hit the marketplace, there was so much vulnerability to psychology and not fact, that you couldn't stand the tide because of the composition of the liability section. And that's a freak company, Senator.

Senator PROXMIRE. That's what?

Mr. KEEFE. A freak company. You won't find other banks whose liability section matches what Continental had. They were funding that bank not with deposits but with Fed funds, commercial paper, Eurodollars.

Senator PROXMIRE. Well, it undoubtedly was an unusual kind of situation, as usually is when a bank fails. As you pointed out, there have been very few failures and, of course, Continental didn't fail. It was bailed out. It would have failed if it had not been bailed out.

Mr. KEEFE. It would have failed, as David said, from liquidity and not because of capital or loan loss.

Senator PROXMIRE. Nevertheless, under most circumstances, and even under those circumstances, if you double your equity, you're less likely to fail than if you don't.

Let me ask you this, Mr. Keefe: Recently, the U.S. Treasury used your rating services to determine which bank should not be used as Federal depositories for the Treasury's general account. I understand that 15 banks are going to be dropped from the eligible list and that 11 of these are minority owned banks—minority owned.

How do you account for this? Does your rating service downgrade minority banks?

Mr. KEEFE. Absolutely not. Absolutely not.

Senator PROXMIRE. How do you account for the fact that a large proportion are minority owned and only a tiny fraction of all banks are minority owned?

Mr. KEEFE. Because that's the way ratios fall, Senator, and I have no control over that. We downgrade the ratings on our own investment banking clients and I can tell you, it makes them madder than a hornet. But we have a system. We have a committee that the ratings go before.

Now, taking them off the list is not our doing. There are a couple of Government agencies that use our rating systems and they make their own decisions as at what level on a rating system. We make no recommendations to anybody, none whatsoever. That's their decision, not ours.

TWO BASIC CHOICES IN A BANK PROBLEM

Senator PROXMIRE. Mr. Ryan, you have had a distinguished 25 years in bank examination. You point out that a bank supervisor has two basic choices in a problem bank situation:

One, he can blow the whistle and go for a cease and desist order or apply other sanctions; two, he can jawbone the bank's management and directors. You say it's your personal opinion that the bank regulatory agencies should probably move more forcibly sooner than they do; that is, they should blow the whistle earlier rather than jawbone.

Why do you think our examination system has this tendency? And what can Congress do to strengthen the mental resolve of examiners to be tougher?

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Mr. RYAN. I think the process has that tendency because the choices are not at all clear.

Senator PROXMIRE. Would you move the mike a little closer?

Mr. RYAN. I said, I think the system has a tendency to delay because the choices are not at all clear in the early stages, when the assets that ultimately cause the problem are being built up. At this point it is not apparent that the lending decisions are inherently bad or that that particular industry is going to get into trouble.

The energy sector is an example. There are institutions that specialize in lending to the energy sector, and many of them are experiencing problems now because there are problems in the energy sector. At what point does the supervisor step in and say that's enough, your exposure to that particular industry is too high? This situation is particularly difficult in the institutions that have carved out a niche in an industry or are serving a market that is dominated by an industry. These are very difficult choices.

Senator PROXMIRE. I'm talking about the technique you used to get action, whether you jawbone or you get tough and go to a cease and desist.

Mr. RYAN. The type of action taken is progressive. Initially, jawboning to the board of directors and trying to persuade them that they should change their policies and change their direction. If there is no response to moral suasion or jawboning, then you have to get a little tougher and move down that continuum and use the ultimate tool, which is removal of management.

Senator PROXMIRE. Mr. Brooks, do you want to comment on that?

Mr. BROOKS. The only comment, Senator, is that for the most part, most of the problem banks are subject to some kind of enforcement agreement, be it a consent order, cease and desist action or memorandum of understanding. To my knowledge, they are pretty much taken care of and, therefore, they are monitored very closely. They are subject to enforcement agreements to the degree that if they are violated the regulator can take even further and stronger sanctions against them in the form of civil money penalties and other actions.

Senator PROXMIRE. Mr. Homan, someone suggested a risk-based insurance premium system might actually be counterproductive—counterproductive in the sense of encouraging increased risk taking. That is, a high-flying bank or a thrift that's charged a higher insurance premium might actually make even riskier loans in order to make up the higher cost of Government insurance.

Do you think that's a significant problem?

Mr. HOMAN. I think that if the risk system is properly planned there should not be a significant problem. It's true that when bankers get in desperate circumstances, the tendency always is to reach a little bit further and perhaps that's a counterproductive effect, but I don't think that's going to be a significant factor at all.

However, adding a risk-based capital standard on top of a simple standard which Mr. Isaac seemed to propose, and Mr. Selby seemed to agree with, may have a tendency to reduce the liquidity of the system for reasons Mr. Selby suggested: that if a bank is constrained on a simple ratio such as capital to assets, the only option is to change the mix once the minimum is reached.

Thus, management may be biased toward higher risk, higher earning assets and away from lower risk assets such as lower earning Government securities or more liquid assets.

Therefore I don't agree with them that we should impose a risk-based system on top of the simple system such as the minimum that they have now in the capital standards. But, certainly, I agree that they can come up with a better formula for capital by using a risk-based analysis of various types.

Senator PROXMIRE. Let me just ask, finally, Mr. Cates and Mr. Keefe. This isn't a question you have to take any time to answer, but would you be willing to work with Federal agencies and staff of this committee in an effort to understand your rating techniques in greater detail and discover how they might assist in the process?

Mr. CATES. Of course.

Mr. KEEFE. We, indeed, do work with the agencies now.

Senator PROXMIRE. With the staff of this committee. They're the ones who wrote the question.

Mr. KEEFE. Pardon?

Senator PROXMIRE. They're the ones who wrote the question.

Mr. KEEFE. Are they going to get paid?

Senator PROXMIRE. You see, we are impressed by your brilliance and they want to know if they could get some of it free.

Mr. KEEFE. You didn't answer my question.

Senator PROXMIRE. What is that, sir?

Mr. KEEFE. My question is, do they get a budget to pay us?

Senator PROXMIRE. It wouldn't be free.

Mr. KEEFE. I didn't say that. I asked the question.

Senator PROXMIRE. Well, you know, I'm the founder of the Golden Fleece Award and I wouldn't want to have to give the Golden Fleece Award to our staff for spending money they didn't have to spend. At any rate, we hope that you'll cooperate and I'm sure you will.

We are very impressed by your ability.

Thank you, gentlemen, very, very much.

[Response to written questions from David C. Cates, Harry V. Keefe, Jr., Paul M. Homan, John E. Ryan, and Thomas A. Brooks follow:]

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RESPONSE TO QUESTIONS OF SENATOR GARN FROM DAVID C. CATES

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November 1, 1985

Q. 1. Should a federal insurance agency be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed institution with any profit after administrative costs arising from the transaction returned to the original stockholders?

Question 1. The question hinges on the issue of shareholder rights, due process, and the prospect of litigation. To wipe out shareholders "prior to economic insolvency" is the equivalent of confiscation. To let regulators manage these distressed properties in the interim is asking them to do more than they are trained for. Finally, who determines the ultimate "profit" and how fair is it to the foreclosed shareholders? I'm not a lawyer, but this solution would get tied up in litigation.

Q. 2. If the burden of mismanagement were placed squarely on the managers and stockholders and most failures were handled through a purchase and assumption at an earlier stage - immediately or through a conservatorship - regardless of size - wouldn't this dispose of the fairness question as it relates to large and small institutions? Why couldn't a Continental type solution be applied to failing small banks? If an insurance agency is funded totally by institutions is there a federal subsidy?

Question 2. Professor Kaufman has recommended the "conservatorship" plan for any bank which becomes "economically insolvent", i.e., the market value of its assets is less than its liabilities. Your question is silent on the issue of "trigger", but I assume you mean insolvency of the Kaufman sort

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I see three problems. One is that the determination of insolvency involves too much of someone's judgment on the collectibility of loans. Who knows what a "middle-market" loan, say, to a still-surviving oil driller or farmer or Houston developer is worth? Another is that the insolvency determination will often hinge on transitory market factors (whether Treasury bonds are $88 or $93, or $93 1/2) that should not really affect survival if these assets are not needed for liquidity.

Finally, a seemingly "fair" plan like Kaufman's may create a swinging door effect, with too many banks "failing" an arbitrary test, creating an embarrassing backlog of unsold properties. Then the government is in the banking business! What is the emergency that demands this solution?

What about this idea? On the assumption (which I take to be fact) that market discipline by funds-providers and other creditors of banks is becoming rational, active and patient, why not establish a fixed, declining payout scheme? To kick it off, the FDIC will pay uninsured depositors off at 99 cents on the dollar in all failures (including P&A) 1987-88, at 98 cents for the 1989-90 failures, 97 cents in 1991-92, and so forth. This will give managements and the market time to adjust to one another. It will keep government out of bank ownership and management oversight, it will be fair to all banks, and it will probably be no more costly to the FDIC than any other scheme.

Q. 3. What can be done to prevent covenants in subordinated debt agreements from requiring the FDIC to prevent losses to all creditors as well as the holding company?

Question 3. Protective covenants are one reason people and institutions buy and hold bonds at a given price. Absent the customary covenants, another class of "junk" securities would be created which penalizes all but the strongest issuers. To diminish covenant protection is like assessing shareholders: it makes some academic theorists feel swell, but it damages access to capital by an industry that is all but 100% privately owned and financed, one (furthermore) in competition with less regulated firms.

Q. 4. Should CPA audits be required of all depository institutions and their holding companies? What steps, if any, should be taken that would permit federal bank examiners to place more reliance on auditors' evaluation of management systems and controls? Would this help examiners focus on asset quality, and bank risk levels, etc.?

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Question 4. The trouble with CPA audits is that they are not worth very much. Though there are such things as "qualified opinions", no audited bank or BHC that has failed since 1970, to my knowledge, entered its crisis with a qualified opinion. To my mind, an unqualified (clean) accounting opinion should at least suggest that the bank will make it through to the next audit. It is instructive to read the legal defense of CPA firms sued because their clients fail. If this language were made part of the normal disclaimer that accompanies every audit engagement, who would rely on the opinion?

Rather than install the costly and uncertain audit barricade against failure, more reliance should be placed on skilled financial analysis by those who can read the forest, not the trees. The work of Keefe and ourselves, for example, is not an accident. Our firm happens to be remarkably accurate about "smelling" trouble from a reading of the numbers, certainly more accurate than the record of CPA firms would indicate about their work.

Why should federal examiners not rely on the "second opinion" represented by the work of private analysts?

Q. 5. What is your view of permitting federal regulators to require institutions to pay special assessments for the increased examinations made necessary by their classification as a problem institution?

Question 5. No opinion.

Q. 6. If regulators are rarely suprised by a bank failure - isn't the answer swifter or more appropriate regulatory action rather than increased market discipline? Wouldn't giving the regulators the ability to close an institution earlier be appropriate? Should a regulator require bank management to file a confidential bank failure plan approved by its board of directors if it falls a certain percentage below its minimum capital level for a specified period of time?

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Question 6. This question presupposes several others. How many bank failures are tolerable? If 150 banks failed, that's just 1% of all banks. If they are small banks, with a few up to $1 billion of assets, assuming a high proportion of P&A solutions, where is the damage to the social fabric? In any case, how avoidable are these failures, given "unit" banking traditions in many states which doom those banks to concentrate their lending on local economies?

I believe that we have not yet reached the tolerable outer limit of the "healthy" failure of smaller-to-medium banks. By "healthy", I mean simply that a private industry as large as banking needs exit as well as entry. Failure is one of the exits. It serves several functions, one of which is to let the rest of the herd run faster, another is to dramatize the unwisdom of the managerial and other practices that lead to failure, for the benefit of the survivors.

What is the correct role of regulatory and market discipline acting together? The former operates on all banks, the latter operates on market-dependent banks (those with, say, more than 20% of their earning assets funded by large-dollar liabilities).

With respect to banks not market-dependent, regulatory process improvement -- in its various possible forms (e.g. better surveillance, better on-site exams, etc.) -- is preferable to premature closing (which creates a fair basis for shareholder suits). With respect to market-dependent banks, the regultory process is turning out to be a tacit partnership among management, regulator and funds-providers. This naturally evolving process should be recognized and encouraged (see enclosed article of mine, soon to be published, "Risk and Creditworthiness"). The work of your Committee does not appear to take this important and real process into account.

Are very large banks different from all others? Yes, because no buyer can be found for a weakened giant, whereas a weakened regional or community can most likely be sold. Thus the regulatory problem presented by the weakness of giant banks is critical to the formation of any fair policy. My recommendations are: recognize and encourage the de facto partnership of management, funds-provider and regulator, they need one another; install risk-based capital concepts; install the payout sequence mentioned above (99%, 98%, 97%, and so forth).

Is capital the best indicator of possible failure? Your question implies that diminished capital might be the trigger for filing a "failure plan". The trouble is that bank failure is caused by the mismanagement of assets, liquidity or controls (or all three), not by the diminution of capital as such. The failure process is already far along by the time capital is diminished by losses. This may be too late to file a failure plan, though that is an interesting idea. Must such a plan be disclosed?

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Q. 7. There appears to be strong support for required risk-based capital - as a method of calculation of capital or as a supplement to the flat rate capital ratios. Would this necessarily lead to higher capital standards? Is there any need for legislation in this area if such risk-based standards were to be applied equally to all institutions?

Question 7. Risk-based capital requires judgment if it is to be applied fairly. The enclosure ("Beyond the Balance Sheet", from ABA Banking Journal, November 1985) shows that the concept of "risk" cannot be simplistically quantified for a bank as is the present, false notion of capital adequacy. To do so would substitute one illogical nightmare for anot r.

Thus examiners must become trained in risk analysis, not an impossible task, one that can even be guided by properly designed "remote" analysis. Fortunately, the real analytic challenge comes from a few hundred larger banks, and is not equally present from all banks.

This should lead to lower capital for theless risky, and more capital for the riskier, in comparison with today's minimum standards.

Note that the Federal Reserve is asking banks to address their "riskiness", for purposes of daylight overdraft control. Whether this program succeeds or fails should be of interest to your Committee.

Q. 8. In 1981 and 1982, the banks and thrifts were suffering from disintermediation - their better customers were flocking to money market funds in droves. Now the concern seems to be that the higher quality loan customers are able to fill their needs elsewhere. The banks point to commercial paper, and the securitization of their loan portfolio. They claim that this trend is being caused in part by their capital ratios and reserve requirements. What is your view? What recommendations do you have for us in this area?

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Question 8. It is true that the "higher quality loan customers", particularly of large banks, have been able to meet much of their financing needs with non-bank instruments such as commercial paper and the securitization of financial assets. The process is an old one, however, and is rooted less in the under-competitiveness of banks than in the evolution of markets, technology, and financial instruments which, taken together, render increasingly obsolete the main product of banks, namely, the loan.

The under-competitiveness of banks is nonetheless a factor in this profound strategic development, and it has two roots. First, the increasingly high capital requirements mandated by regulators carries with it a high cost-of-capital, which has the effect of placing high-quality assets out of reach. Since banks are stockholder-owned, the cost-of-capital discipline -- including a market-attractive rate of return on shareholders equity -- is not one that can be avoided. To meet those targets, banks are forced to acquire lower-quality, higher-yield assets which, unforunately, are also higher-risk. Middle-market and third-world loans are examples of these assets.

Second, Glass-Steagall and other restrictions on the activities of banks prevent them from participating in the evolution of those markets that have to some extent superseded the traditional role of banks. Thus they are left with an increasingly obsolete and risky product line.

The competitiveness of banks, consistent with their safety and soundness, ought to be a primary goal of public policy. Absent a pro-competitive policy, our larger banks are weakened relative to large foreign banks and may suffer the loss of their worldwide industry leadership.

The maintenance of American bank competitiveness requires, first, that the thrust of regulation be directed more at monitoring the risk profile of banks -- their liquidity, lending, and controls -- than at the attainment of higher capital. Mere capital strength is a false solution, and also a lazy one, since it is an oversimplified solution to the true risk situation of banks in general and of particular banks. Second, our larger banks should be permitted to operate in those markets that are loan-substitutes, namely commercial paper and other securities underwriting.

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Q. 9. Mr. Isaac has stated that a significant number of bank failures are caused by fraud other than increased enforcement actions which are being taken by the federal agencies - aren't Mr. Homan (Former Senior Deputy Comptroller for Bank Supervision, Office of the Comptroller of the Currency) and Mr. Ryan (Former Director, Division of Banking Supervision and Regulation, Federal Reserve System) right as to the importance of the ON-SITE exam to ascertain the integrity of the numbers being generated and the lack of fraud? If so, does the decrease in on-site examinations bring with it an increase in the risk of fraud? If so, how can this be corrected?

Question 9. You cannot catch them all! Fortunately, fraud in clean-looking banks is statistically very rare. In large banks it is embarrassing but not life-threatening. We have discovered, in our quantitative risk monitoring of banks, that fraud-induced failures usually occur in funny-looking banks, never in strong-looking banks. Thus the fraud problem, from a systemic standpoint, is manageable. This analysis needs to be further supported by a study which confirms and refines my belief that fraud gives off detectable "smoke."

If so, on-site exams can be deferred in those banks that check out clean on a surveillance basis, provided the surveillance is properly conducted via a sufficiently complex system that protects the regulator against being "blind-sided" by bank performance that masks actual high risk.

Q. 10. In your opinion, what are the advantages and the disadvantages of risk-based capital and risk-based premiums? Should we consider one or the other or both? Why?

Question 10. I've already discussed risk-based capital. As for risk-based premiums, my fear is that an explicit system can be simulated by private computers, and that the fact of "high risk" status will, in any case, leak to the market. This will then lead to self-fulfilling prophecies that will cripple or break banks that simply do not deserve such draconian treatment from the market. Market discipline ought to be a judgment process in which the market, not the government, makes the judgment. When government is the source of the judgment, the discipline of the market becomes lazy and ill-informed. Thus I am opposed to risk-based insurance. Fortunately, a solid matrix of bank risk management does not need this destabilizing feature.

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Q. 11. What is your view of Mr. Keefe's suggestions that

a. The current loan limit is too high?

b. Many banks fail due to excessive concentration?

c. A bank be required to list its 30 largest borrowers by type of company?

d. The largest banks be required to supply regulators with monthly data?

Question 11. Harry Keefe's suggestions are minor remedies. The loan limit is not a problem by itself, but only in the context of mismanagement otherwise discernible. Excessive concentration kills small banks, and is in any case detectable in ordinary examination. Disclosure of concentration (his suggestion "C") is a good idea, but riskless overnight lending to large corporations should be excluded from the list. Monthly reporting is unnecessary, except by those banks under special observation arising from enforcement orders.

I will be happy to clarify or expand upon any of these answers, should your Committee wish. In conclusion, I urge that the riskiness of banks -- with its possible costs to the FDIC insurance fund -- be viewed as though it were a problem in public health administration. Seen this way, the public danger needs to be objectively evaluated, and the proposed remedies should be appropriate, feasible, low-cost, and should not create disruptive side-effects. Such an approach would start, I believe, with the recognition that 90 out of 100 banks are in no danger of failure, and that nine out of the remaining ten can be guided back to health.

Thanks again for the opportunity to present these views.

Very truly yours,

David C. Cates
President

DCC:yn
Enclosures

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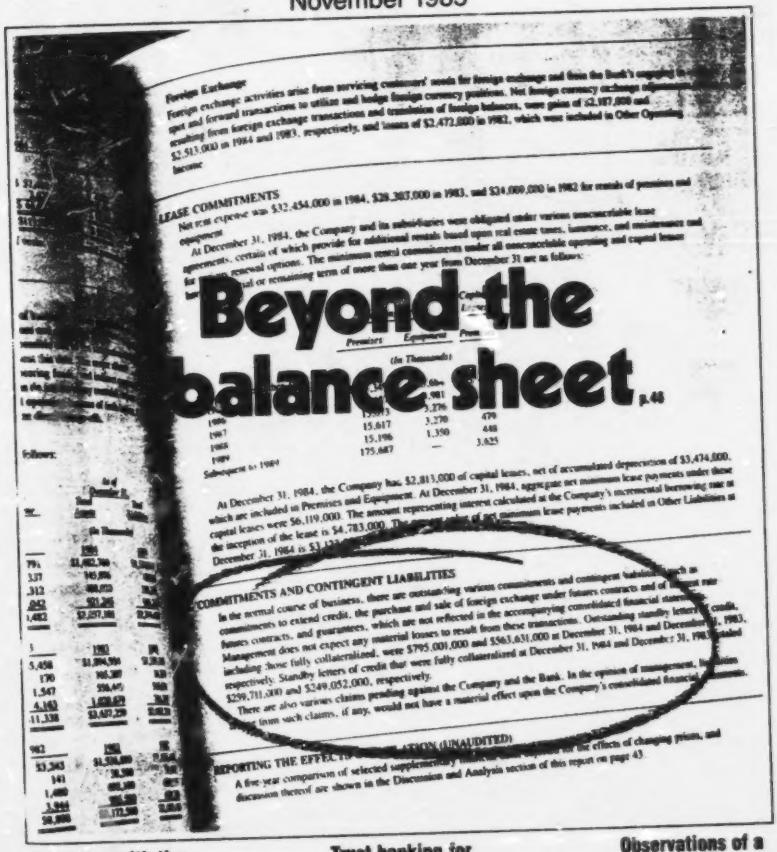
ABA
Banking Journal

November 1985



Foreign Exchange

Foreign exchange activities arise from servicing customers' needs for foreign exchange and from the Bank's engaging in spot and forward transactions to utilize and hedge foreign currency positions. Net foreign currency exchange adjustments resulting from foreign exchange transactions and translation of foreign balances, were gains of $2,987,000 and $2,513,000 in 1984 and 1983, respectively, and losses of $2,472,000 in 1982, which were included in Other Operating Income.

LEASE COMMITMENTS

Net rent expense was $32,454,000 in 1984, $28,307,000 in 1983, and $24,009,000 in 1982 for rentals of premises and equipment.

At December 31, 1984, the Company and its subsidiaries were obligated under various noncancelable lease agreements, certain of which provide for additional rentals based upon real estate taxes, insurance, and maintenance and for renewal options. The minimum rental commitments under all noncancelable operating and capital leases having an original or remaining term of more than one year from December 31 are as follows:

Beyond the balance sheet p.46

	Premises	Equipment	Total
	(In Thousands)		
1986	15,967	3,276	19,243
1987	15,617	3,270	470
1988	15,196	1,350	448
1989	175,647	—	3,625
Subsequent to 1989			

At December 31, 1984, the Company has $2,813,000 of capital leases, net of accumulated depreciation of $3,474,000, which are included in Premises and Equipment. At December 31, 1984, aggregate net minimum lease payments under these capital leases were $6,119,000. The amount representing interest calculated at the Company's incremental borrowing rate at the inception of the lease is $4,783,000. The [illegible] value of net minimum lease payments included in Other Liabilities at December 31, 1984 is $3,[illegible]

COMMITMENTS AND CONTINGENT LIABILITIES

In the normal course of business, there are outstanding various commitments and contingent liabilities such as commitments to extend credit, the purchase and sale of foreign exchange under futures contracts and of interest rate futures contracts, and guarantees, which are not reflected in the accompanying consolidated financial statements. Credit Management does not expect any material losses to result from these transactions. Outstanding standby letters of credit, including those fully collateralized, were $795,001,000 and $563,631,000 at December 31, 1984 and December 31, 1983, respectively. Standby letters of credit that were fully collateralized at December 31, 1984 and December 31, 1983 totaled $259,711,000 and $249,052,000, respectively.

There are also various claims pending against the Company and the Bank. In the opinion of management, [illegible] from such claims, if any, would not have a material effect upon the Company's consolidated financial [illegible]

REPORTING THE EFFE[illegible]ATION (UNAUDITED)

A five-year comparison of selected supplemental [illegible] for the effects of changing prices, and discussion thereof are shown in the Discussion and Analysis section of this report on page 43.

Grappling with the farm crisis p.25

Trust banking for any size bank p.73

Observations of a merger maker p.75

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A balanced look at "OBS" exposures

Off-balance-sheet, that is. They're a growing part of banking. And "return on exposure" (ROX) is an inevitable new profit yardstick

By Tom Bisky

The "invisible" bank. That's what some banking analysts and regulators call the array of fee-paid loan commitments, standby letters of credit, futures contracts, and other creditlike exposures that are not reflected on a bank's "visible" balance sheet or conventional financial statements. Such off-balance sheet (OBS) activities are now commonplace in the largest banks.

Granted, many commercial banks are virtually riskless in their OBS activities, because their operational, credit, and trading controls are so strong. Nonetheless, some regulators view the boom in OBS commitments with concern and are taking steps to tighten constraints or require detailed disclosure. Federal Reserve Board Chairman Paul Volcker, for example, recently attacked what he termed "exotic" new off-balance-sheet lending arrangements. The Fed also has announced that it will shortly propose a new method of accounting for off-balance-sheet risk.

To look into banking's forays off the balance sheet, *ABA Banking Journal* recently spoke at length with a money center banker and a leading risk analyst.

- Peter J. Tobin, CPA, is senior vice-president and controller, Manufacturers Hanover Trust Company, New York. As of last December, Manufacturers Hanover's total dollar commitment in standby letters of credit—a major OBS category—equaled 26% of the bank's $45 billion in total loans outstanding.
- David C. Cates is president of Cates Consulting Analysts, Inc., New York. The firm regularly compiles OBS statistics to issue risk and performance ratings on hundreds of banks and bank holding companies.

Peter J. Tobin, Manufacturers Hanover

David C. Cates, Cates Consulting Analysts

In the following discussion, Cates and Tobin explore how specific kinds of OBS commitments and contingencies variously expose a bank to credit risk, interest rate risk, market risk, operating risk, or capital risk. In addition, Tobin explains how Manufacturers Hanover has fashioned a new, customer-specific profit indicator—"return on exposure" (ROX). This indicator helps the bank decide whether it is earning enough to compensate for the overall level of risk to which it is exposed by a given customer relationship.

ABA BJ: David, why are regulators suddenly taking such an interest in OBS banking?

Cates: An unavoidable stimulus is publicity about the "explosion" in OBS activity. Also, since 1982, some banks have been steadily reducing their internal liquidity as one way to comply with new capital regulations. This naturally troubles regulators, who see their capital policy as having degenerated into a disincentive for liquidity.

A third reason for the interest in OBS banking—and a strange one—is that U.S. banking regulators don't want to fall behind the rest of the world. Central bankers in the United Kingdom, Germany, and other countries are moving to take greater account of OBS risk. The Bank of England started it all by looking at capital adequacy vis-a-vis standby letters of credit. It has since gone well beyond that, albeit somewhat informally. Believe it or not, our regulators simply don't want to appear behind the times in the international fraternity of central bankers.

ABA BJ: As a money center banker, Peter, have you felt increased regulatory pressures regarding OBS banking in recent months?

Tobin: Not just that recently. Publicity aside, OBS risk isn't a new concern. In fact, I believe the latest minimum guidelines for capital already took OBS exposures somewhat into account. And the Fed, in its examination and oversight procedures, has been informally administering a range of capital-to-assets minimums depending on the risk profile of each bank, including the amount of OBS banking.

Cates: That must vary from district to district, though. I'll bet the New York Fed, for example, is much more attuned to risk-adjusted capital—a good buzzword for what we're talking about—than, say, the Richmond Fed.

Tobin: I'd assume so. Mind you, regulators haven't yet hit upon a risk adjustment formula. They just seem to have a certain experienced feel for capital requirements that comes across when they're surveying banking risks.

Cates: And let's hope that their approach never does become a clinical for-

From his home in Warwick, N.Y., Mr. Bisky, a former associate editor of *ABA Banking Journal*, writes about banking, accounting, and other financial topics.

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Schedule L is the primary source of public data on banks off-balance-sheet activities, but it's not complete

mula. After all, what hard and fast rules could possibly prescribe capital minimums for OBS exposure or its corollary, the risk component of the visible balance sheet? Once you start writing rules—for instance, that any standby letter of credit requires 50% of the capital of a loan—you're just substituting one compliance and enforcement nightmare for another.

Tobin: I agree totally. For starters, every institution's loan portfolio has its own unique risk profile, no two are identical. Similarly, the standby portfolio will probably vary in quality from one bank to another.

Cates: To some extent, banking products do differ in riskiness. But to a great or extent, the *management* of banking products differs in riskiness. For example, construction loans are intrinsically riskier than overnight credits. But I'll wager we could find banks that are riskier in their overnights than in their construction loans. The industry needs to emphasize this distinction in its talks with its regulators.

It's encouraging to learn recently that the Fed would begin allowing banks to evaluate their own risk levels for purposes of wire transfer overdraft control. The Fed seems to be saying: "Decide your own risk profile for credit controls on counterparties, for operational controls on sending and receiving technology, and for creditworthiness. You decide, then we'll review your decisions." If this experiment in self-regulation works, it may become a precedent for dealing with such fast-moving, hard-to-quantify exposures as those connected with OBS banking. At least, I certainly hope so.

ABA BJ: Since Sept. 30, 1983, banks have had to file Schedule L—"Commitments and Contingencies"—with each Report of Condition. Schedule L is still the only public source of OBS data on individual institutions, other than footnotes to financial statements, which are very limited. Yet some people feel Schedule L raises more questions than it answers.

Tobin: Certainly, the two dozen or so line items on Schedule L represent a broad miscellany of OBS risk.

Cates: That raises an interesting point.

Schedule RC-L – Commitments and Contingencies

Please read carefully the instructions for the preparation of Schedule RC-L.

Dollar Amounts in Thousands	C480 Bil	Mil	Thou	
1. Commitments to make or purchase loans or to extend credit in the form of lease financing arrangements (report only the unused portions of commitments that are fee paid or otherwise legally binding)	RCFD			1.
2. Futures and forward contracts (exclude contracts involving foreign exchange)	RCFD			2.a
a. Commitments to purchase	RCFD			2.b
b. Commitments to sell	RCFD			
3. When-issued securities	RCFD			3.a
a. Gross commitments to purchase	RCFD			3.b
b. Gross commitments to sell	RCFD			
4. Standby contracts and other option arrangements	RCFD			4.a
a. Obligations to purchase under option contracts	RCFD			4.b
b. Obligations to sell under option contracts	RCFD			5.
5. Commitments to purchase foreign currencies and U.S. dollar exchange (spot and forward)	RCFD			
6. Standby letters of credit and foreign office guarantees	RCFD			
a. Standby letters of credit and foreign office guarantees	RCFD			6.a (1)
(1) To U.S. addressees (domicile)	RCFD			6.a (2)
(2) To non-U.S. addressees (domicile)	RCFD			
b. Amount of standby letters of credit in items 6.a (1) and 6.a (2) conveyed to others through participations	RCFD			6.b
7. Commercial and similar letters of credit	RCFD			7.
8. Participations in acceptances (as described in the instructions) conveyed to others by the reporting bank	RCFD			8.
9. Participations in acceptances (as described in the instructions) acquired by the reporting (accepting) bank	RCFD			9.
10. Securities borrowed	RCFD			10.
11. Securities lent	RCFD			11.
12. Other significant commitments and contingencies (list below each component of this item over 25% of Schedule RC, item 28, "Total equity capital")	RCFD			12.

Memoranda

1. Loans originated by the reporting bank that have been sold or participated to others during the calendar quarter ending with the report date (exclude the portions of such loans retained by the reporting bank; see instructions for other exclusions)	RCFD			M.1
2. Notional values of all outstanding interest rate swaps	RCFD			M.2

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"OBS risk" has emerged as a catch phrase. It almost implies that a bank has an OBS division, with a single executive in charge. But OBS isn't one homogeneous business; it's not even a closely related family of businesses. It's extremely diverse. None of these products' exposures are captured on visible financial statements. But that doesn't mean they have lots in common. So when you ask "Who's in charge of OBS?" you don't get a clear answer. The person in charge is simply the one running the division where a particular exposure makes sense.

Tobin: I'd say that the line officer is responsible for the customer's exposure, whether in an OBS contingency or a conventional loan. But at Manufacturers Hanover, we have other control points too. For instance, in my office we do a quarterly comparative OBS analysis of our peer group—the top ten banks in the country. We look at all Schedule L items, especially standbys, and compare gross levels, growth rates, and so forth. This material along with detailed analyses of our own portfolio as to credit grade, purpose, pricing, etc. are reviewed frequently by our credit policy committee. There's certainly no dearth of publically available data on the subject. At the moment, the rating agencies are trying to get a better handle on OBS risk and what it means.

ABA BJ: Let's proceed, then, by examining which OBS commitments and contingencies Schedule L captures and which it doesn't. Let's at least make *relative* risk comparisons.

Tobin: All right. Take the standby letter of credit. Next to an actual loan outstanding, the standby probably represents a bank's strongest commitment to a customer. There are far fewer escape hatches or covenants to prevent a customer from drawing on a standby than on any other Schedule L item. After that come loan commitments, including revolving credits, which extend over lengthy periods. Most loan commitments have a few more covenants, typically that have to be observed by both parties before they can be drawn on. So, if there's a stepping order of riskiness implicit in Schedule L, then standbys should be at the top. The other items follow pretty much in the order they appear on the schedule. But, as we've observed, the big problem is *quantifying* risk comparisons.

Cates: It's worth pointing out that Schedule L doesn't include many OBS risks, among them the unused commitments under lines of credit that aren't legally binding, such as Federal funds lines.

ABA BJ: Would you define Fed funds lines as a form of OBS exposure?

Cates: As a practical matter, I'm not sure. Peter, do you track your downstream banks' utilization of Fed funds lines? If it rose, say, from 30% to 80%, would you readjust all those lines?

Tobin: I'm not involved in this activity on a day-to-day basis, but my understanding is that it's not quite that way. Our correspondent banking group establishes the lines, but a senior customer-account officer must sign off on each. Day-to-day dealing in the lines is through the money desk. If our liability people felt they needed to increase a given line, they could request it. But that request would go through our usual credit control process, just like any other extension of credit. Credit responsibility rests with the senior lending officer in charge of the account, who must be cognizant of the customer's total exposure at any time.

A similar area not covered in Schedule L is a general line of credit to an individual. We don't report such a line as a commitment because it's not legally binding and because we receive no fee for it.

ABA BJ: Let's go to lines 2(a) and 2(b), which cover commitments to purchase and to sell, respectively, under futures and forward contracts, excluding foreign exchange.

Cates: If those lines are in balance, Peter, does that mean there's no risk involved?

Tobin: No. The risk in such transactions is not directly related to the principal amount—the amount reported. Rather, risk is related to the change in interest rates over the contract terms, and you

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can't calculate that from Schedule L. But that doesn't mean there's no exposure.

This is part of the problem the industry is wrestling with constantly. Many people may want to consider standbys as the only Schedule L items with attached risk. But my bank believes all the items should be considered, and relative risk defined as precisely as possible.

Cates: In other words, a bank could have a gross matched position and still be mismatched in the future area, even though lines 2(a) and 2(b) don't indicate that?

Tobin: Yes. Very often, a bank can enter into a futures transaction to offset a cash position—either an asset or a liability—on its balance sheet. So, sometimes, lines 2(a) and 2(b) won't be directly related.

Cates: I take it, then, that you wouldn't agree with an economist whom I recently heard. He proclaimed that one of those two lines exceeding the other would signal which direction the bank thought interest rates were heading.

Tobin: That's a terribly dangerous assumption, I'm afraid.

Likewise, one could vastly overstate the risk associated with interest rate swaps by misinterpreting the total dollar figure required as of June 30, 1985 on a new line of Schedule L. That figure is the *notional principal* amount committed in interest rate swaps. The problem is that the principal isn't at risk—only the streams of interest payments are subject to risk based on a third party failing to make required interest payments, and on fluctuations in interest rates. We've done studies showing that in the worst possible case, assuming failure in simple interest rate swap transactions under a very tough rate scenario, the most we could lose or gain is about 15% of the principal. That's very different, mind you, from saying that we're exposed to a 15% risk of failure in any interest rate swap transaction. So to assume that the huge principal amount reported on the new Schedule L is "at risk" would be completely wrong.

Of course, any bank could lose money on a swap by outright speculation. But commercial banks aren't in the interest rate swap business for speculation. They're in it to provide legitimate financing tools for their customers. The critical safeguard is to make sure that the people managing these tools are knowledgeable and observe scrupulous control procedures.

Cates: Let's shift gears a bit. A year or so ago, a senior credit officer at a good-sized regional bank told me he'd been thinking about establishing a bankwide exposure committee. He felt the bank's credit-like exposures had gone far beyond the loan division. Does Manufacturers Hanover have such a control structure in place?

Tobin: We have many such controls. Our credit policy committee looks at exposures of major customers, both on and off the balance sheet.

We also look closely at the customer relationship when pricing deals. We calculate not only a customer-specific ROA but also a "return on exposure" (ROX) to determine whether we're properly compensated for the total exposure that a customer relationship represents. It's a profit calculation exercise separate from the imposition of credit controls. Essentially, our money committee asks whether we're getting paid enough—not on a specific deal, but on the total relationship.

> ***"Off-balance-sheet business isn't homogenous; it's not even a closely related family of businesses"***

ABA BJ: From your peer-group studies, Peter, would you say that most large banks calculate an ROX?

Tobin: I can't vouch for it, but I'd bet on it.

Cates: It certainly sounds like an inevitable development to look at total exposure to a customer and then calculate how profitable it is.

I often wonder, in general, how much potential for profit OBS banking represents. In examining the noninterest income section of many large banks' financial statements, I've noticed that the OBS contribution isn't much larger than the contribution in slightly smaller banks where OBS activity is negligible. In other words, off-balance sheet dollars don't seem to include much profit margin.

Tobin: I really don't believe that is the case. The larger banks have significant levels of OBS income but in any business, as a product matures, its returns

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"In many ways, the deposit, the loan, and the investment are becoming obsolete in today's market"

shrink somewhat because of competition. Eventually, profit reaches a plateau.

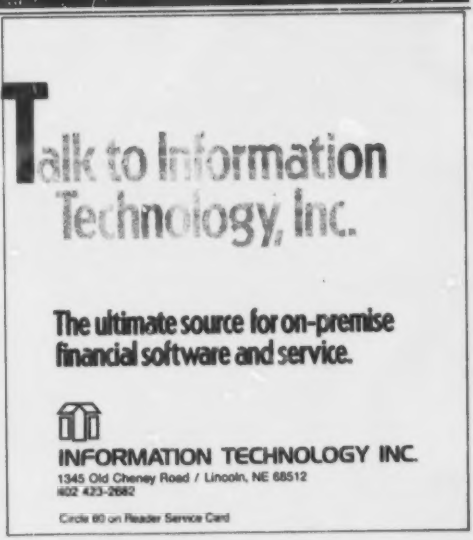
Cates: Banks are now facing capacity limitations, because regulators are forcing them to ascribe a cost of capital to OBS activities. This can lead to only one of two things: diminished activity or higher prices. The latter, of course, would be a favorable consequence for banking. Offsetting this pricing opportunity, however, is the very real threat that less regulated foreign banks would continue to underprice their off-balance-sheet products.

ABA BJ: If prices for certain OBS items do go up significantly, might demand not correspondingly dry up?

Cates: I don't think so. Demand for fancy financial instruments—from credit enhancements to new trading devices—is a function of technology, sophistication, and interest rate volatility. All of these phenomena are here to stay. In many ways, the deposit, the loan, and the investment—which used to be central to the definition of a commercial bank—are becoming obsolete in today's marketplace.

Robins: I don't think demand will dry up for any OBS items or other sophisticated financial tools. At the same time, I think there will always be a place for traditionally funded credits. Some institutions may choose to concentrate more on the so-called investment banking business, but there will still be plenty of commercial banks that will continue to originate, hold, and fund loan assets. Such customer relationships are and will continue to be an important element of the investment banking business of commercial banks.

Cates: At least ten years ago, I read a provocative statement: railroads should have thought of themselves as being in the transportation business, rather than the railroad business. Today, banks ought to think of themselves not as the deposit-and-loan business, but as the financial information business. Whether on or off the balance sheet, financial information is the common thread in everything banks do.□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CATES CONSULTING ANALYSTS, INC.

October, 1985

RISK AND CREDITWORTHINESS: TWIN FINANCIAL INDUSTRY CHALLENGES

David C. Cates

Explorers of the financial industry, like miners, work many veins of opportunity. Even a generalist today has more than a passing acquaintance with the main ore shafts -- markets, products, technology -- and with the chief hazards -- competition and regulation. In recent years a new hazard, like ground water starting to swirl about the knees, has become increasingly insistent. This new challenge, one of whose names is risk, the other creditworthiness, promises to reshape the financial industry as profoundly as any other force. This will happen because competitive advantage flows to those institutions best able to command markets for their financial instruments, whether CDs, letters of credit, debentures or stock.

To describe this set of issues, we will go back to the first stirrings of financial industry creditworthiness concerns in 1973. Next we will outline the much stronger current appetite for creditworthiness analysis. We will then assess the likely impact of creditworthiness as a competitive factor. Following this, we will look at the role of creditworthiness standards as a tool in the governance of financial industry risk. Finally, we will suggest steps that managements can take today.

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Origins. As recently as 1970 there was virtually no belief on the part of either funds-provider or regulator that financial industry risk required special notice. The growing volumes of bank holding company (BHC) commercial paper and term debt, for example, were easily placed without the need for credit ratings. The interbank Fed funds market operated with sparse analytic control, and large depositors, with few exceptions, took no steps to evaluate bank risk. Moreover, bankers' self-image of their industry's credit standing at that time hovered somewhere between "triple-A" and "holiness". As for the thrift industry, its creditworthiness seemed assured by the endless prospect of regulated savings rates. Besides, thrifts (unlike commercial banks) did not then depend on large-dollar funding, so the question of thrift credit was irrelevant.

In 1973 this artificial paradise was desecrated, slightly but fatally, by the growing refusal of institutional investors to purchase non-rated BHC paper. Quickly, Standard & Poor's Corp. and Moody's Investors Service geared up to rate BHC debt, a step they had formerly vowed never to undertake. Partic.-pants in that process will recall the outrage of many world-class banks at having to accept ratings at all (even triple-A!) and the greater outrage of those large regional banks for whom only a double-A was destined. The fear of the former was that their ratings could only fall; the anger of the

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latter was that their ratings weren't the highest.

The first ratings were extremely strong. The money center banks, without exception, started off with triple-A tags on their term debt, while their commercial paper was all "1-rated". A few large regionals were triple-A, most were double-A. It has all been downhill since then.

Other commercial sources of bank/BHC ratings sprang up in the years after Moody's and S&P began their ratings. This expansion of bank rating services, however, could not have occurred without government publication, starting in 1973, of the financial statements of all banks in a machine-readable tape format. A companion development was the emergence (in the mid-1970s) of logical and comprehensive financial disclosure standards, without which reliable, comparative analytic systems could not have been built. The SEC, working with a task force of bank analysts organized by the Financial Analysts Federation, was the leader in this important reform.

Nothing of the sort has overtaken the thrift industry. Though many thrifts sport strong ratings on their standby letters of credit, these LCs are all collateralized by packages of high-grade mortgages. No thrift enjoys investment-grade ratings on its unsecured debt, similar to the ratings that hundreds of banks and BHCs have achieved.

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Why has the thrift industry lagged in the documentation of its credit standing? The answer is complex. Heading the list of reasons is the industry crisis that began in 1980 and has not yet run its course. This has already taken a heavy toll of institutions unprepared for high interest rates, deposit deregulation, and the opportunity to compete for riskier assets. But this is not all. Compared to banks, thrift financial disclosure is opaque and misleading. This is partly because the Federal Home Loan Bank Board, in designing disclosure requirements for thrifts, has preferred the role of cosmetologist to truth-teller, and partly because the SEC never led a financial disclosure reform movement for this industry as it did for banking.

Finally, few thrift managements, unlike their commercial banker counterparts, have yet realized the importance of attaining documented, explicit creditworthiness as a precondition of competitive strength. To take this step requires more than good intentions. It also takes a commitment to establish internal disciplines regarding financial reporting standards, internal accounting standards, the setting of corporate goals consistent with the maintenance of financial strength, and continual effective liaison with rating agencies and the credit marketplace.

Though bankers are to be admired for their submission to

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the rating process and mastery of its various disciplines, the results are less admirable. The bottom line is that large banks -- money center and regional alike -- have suffered, since their first ratings, a decline in ratings more pronounced than their foreign peers and their domestic non-bank peers.

To illustrate, let's compare Moody's and S&P ratings from year-end 1977 through September 1985. In the earlier period, there were a dozen triple-A ratings, today there is only one (J.P. Morgan & Co.). Foreign banks, largely unrated in 1977, have since earned a good share of triple-A ratings (Credit Suisse, Swiss Bank Corp., Union Bank, Industrial Bank of Japan). As for non-bank financial companies, triple-A ratings are enjoyed by several insurance companies (for example, Aetna, AIG, Prudential, Travelers). Finally, the non-financial world of companies is represented by a number of triple-A's (Coca Cola, Kodak, IBM, Proctor & Gamble, among others).

Whatever the reasons, our large banks today are viewed by the two leading rating agencies as less than top credits. Thrifts, by and large, lack credit ratings altogether, except when they pledge assets to secure letters of credit.

For any financial intermediary, this is an unsatisfying state of affairs, with strategic implications. Before we develop this idea, however, let's turn to the wider setting of

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financial industry creditworthiness judgments today. After all, the rating agencies may have misperceived banks, and we do not want to base a strategic interpretation upon too narrow a piece of evidence.

Creditworthiness: A New Buzzword. The fact is that the appetite for bank and thrift ratings is expanding rapidly. No "industry statistics" exist to prove this, but the experience of our firm -- and other vendors of bank and thrift credit analytic materials -- confirms the assertion that demand for credit analysis is building.

Where is it coming from? The interbank credit market is one very large source. Banks, of course, are exposed in many ways to the credit of other banks. Fed funds lines, bankers acceptances, bank stock loans, deposit placements, BHC commercial paper "backup" lines, and direct loans to banks and BHCs are prime examples of interbank instruments. More recently, the growth of interest-rate swap brokerage has exposed intermediary banks to the credit of the swapping parties, and vice versa. Finally, securities lending, foreign exchange trading and wire transfer volume frequently involve banks as counterparties. Credit controls along all of these exposure frontiers are gradually being put in place.

Corporate and governmental interest in the soundness of

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banks is also large. Not only do businesses and public bodies have transaction accounts at banks and thrifts, they often use these institutions as sources of short-term investments. Just as important is the growth of letters of credit and other financial guarantees to support corporate and public financing. Looming in the background, moreover, is the increasing determination of the FDIC and FSLIC to protect themselves against financial risk from insured depositories. Thus their viewpoint is becoming increasingly credit analytic.

Another group increasingly interested in financial industry soundness is the insurers of banks, notably director and officer coverage. Though the use of financial analysis by this constituency is currently low, so is their current willingness to provide coverage.

The driving force behind this appetite for credit analysis of banks and thrifts is the rising perception of financial industry riskiness. This perception has several roots in recent history. First, there have been too many failures and crises for comfort. To be sure, the bank failure rate is remarkably low, but the trendline is steep in the wrong direction. Besides, the crisis of Chicago's Continental Bank, unexpected as it was, had a traumatic effect on public psychology. Second, the financial industry is in flux. Commercial banks are seizing new opportunities and seeking new

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powers. The largest banks are emphasizing lines of business that barely existed a decade ago. Thrifts are struggling to redefine their destiny, with heavy casualties. The public is asking if the managements now in place can guide and control this process! Can bankers ride the whirlwind?

A third stimulus to public perception of financial industry riskiness is that the regulators themselves are conveying their own nervousness to the public. For example, in May 1984, on the occasion of the Continental crisis, the Treasury (seconded by all the bank regulators) guaranteed all the liabilities of the nation's largest banks, a federal bear hug which no bank publicly opposed! This single step perhaps destroyed more confidence than it inspired. Since then, regulators have created a heavy stream of publicity about underfunded deposit insurance, the need for significantly higher capital, the notion that one-eighth of commercial banks are risky enough to pay higher premiums to the FDIC, and the far worse situation among the thrifts. No wonder the uninsured funds-provider is a little less complacent each year. No wonder the holder of a bank standby letter or other commitment begins to consider the creditworthiness of the issuer.

Where has the analytic skill originated that can discern the relative creditworthiness of banks and bank holding companies? The answer is clear. The prophets of risk and

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creditworthiness have been financial analysts, usually with a background in security analysis and usually working from a base in the credit markets. Our firm, for example, has correctly predicted all the failures and near-failures of recent years as "highest risk", and other firms have comparable records. The basic method of these vendors is to use ratio analysis as a guide to judgment.

It is worth pointing out that this analytic discipline is entirely distinct from auditing. Indeed, it can be said about accountants and analysts that they (like the British and Americans) are divided by a common language, in this case the language of financial statements. As for the comfort value of an accounting certificate, for purposes of credit analysis, it may be noted that no audited bank or bank holding company has entered its crisis of survival with a "qualified opinion" attached to its financials. On the contrary, all the celebrated bank crises of recent years -- First Pennsylvania, Penn Square, Metropolitan, Abilene, Midland, SeaFirst, Continental and Heritage (among others) -- had clean opinions from their outside auditors, suggesting at the least that the institution might just make it through to the next audit without failure or rescue.

We will conclude this look at the state of creditworthiness concerns today by describing the interesting experiment in

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self-analysis introduced by the Federal Reserve Board in May of 1985. In its effort to control "daylight overdraft" risk (i.e., the risk of settlement failure on large-dollar payments networks), the Fed has urged all banks incurring overdrafts on these networks to evaluate their capacity to sustain this risk. One of the three criteria of self-evaluation is credit-worthiness, defined by the Fed as "the ability of a bank to fund itself rapidly". Since funding capacity is an important backstop supporting funds transfer volume, it makes sense to evaluate a bank's access to funding markets as one measure of the limits to be set on its overdraft capacity.

The guidelines published by the Fed, though deliberately suggestive and non-specific in nature, place a strong emphasis on comparative ratio analysis as one of the disciplines banks should apply in creditworthiness self-assessment. The rationale for this emphasis is two-fold: first, since ratio analysis of financial performance is the basic technique applied by market-based credit analysts, banks can best simulate the judgment of the market by performing this type of analysis on themselves; second, since ratio analysis takes place in a comparative context, its use tends to counter any bias toward unrealistic or wishful management thinking.

As if to underscore their intent that banks take this new form of regulation seriously, the Fed governors have required

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that bank boards of directors become directly involved in the self-evaluation. This means that each complying bank's board must review, discuss and approve the creditworthiness rating ("excellent", very good", "adequate", or "below standard") which its management recommends. Further, the minutes of board discussion are to be part of the file available for review by the bank's ordinary examiner. This examiner will evaluate, among other things, the "seriousness and diligence" with which the whole exercise was conducted.

All depository institutions incurring overdrafts on payment networks, however infrequently, are covered by this new and unprecedented regulatory policy. This includes, in addition to U.S. commercial banks, foreign bank branches and agencies, Edge Act affiliates, thrifts and credit unions. The result of each institution's self-evaluation is that its maximum overdraft capacity will be limited to a specified multiple of its capital: the highest attainable "cap" is equal to two times capital (based on biweekly averages), the lowest is zero.

It will be absorbing to watch how the financial industry responds to this experiment in self-regulation. Will managements and directors gravitate toward minimal compliance, creating reports which mechanize and trivialize the self-assessment process? Or will directors come to believe that their semi-annual discussions constitute a recurring and

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explicit "attestation of soundness", with implications for director liability, liability insurance coverage, and accountability to shareholders? Directors aside, will managements come to believe that these reports, if thoroughly prepared, will have value as management information in the conduct of corporate planning and risk management? Will managements push their boards to adopt the highest possible ratings as a key to preserving or expanding market share in the payments environment?

However the industry answers these questions, the Fed is determined to achieve its own objective, namely, to establish credit and operational controls over funds transfer volume, where none has existed so far. If the industry is not constructively responsive to the self-regulatory challenge, the failed experiment will be succeeded by direct regulation. If the industry is responsive, the self-regulatory model could be the precedent for the control of other, newer forms of banking risk.

Creditworthiness as a Competitive Tool. The Fed's policy on daylight overdrafts is a clear and dramatic example of creditworthiness as a competitive weapon. Wire transfer capacity, of course, is an important financial product with which banks and thrifts attract corporate clients. Thus there is bound to be a competitive reshuffling as banks with low

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overdraft limits sacrifice some of their business to those with higher limits.

Are there other instances of banks and thrifts sorting out their competitive standing with one another according to creditworthiness factors? We'll look at three examples from the private sector and one example where government wants to play a role.

First, large-dollar funding is clearly sensitive to credit factors, not just in the cost of funds but in the depth and breadth of funds sources. This is most apparent when markets tighten and the "tiering" of banks becomes noticeable. The lowest tier banks then withdraw from remote and impersonal markets, seeking their large-dollar funding closer to home. The highest tier banks pay the least for funds, and are usually offered more than they take.

Tiering, of course occurs not only among banks, but between banks and their clients. As we have seen, lowest-cost funding has become the Paradise Lost for a number of large banks, since their credit standing is no better (sometimes worse) than that of their large clients.

Second, credit standing plays an even more important role in the rapidly expanding world of financial guarantees

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(unfunded instruments which enhance the credit of others). The standby LC of a triple-A issuer is clearly worth more to third parties than the LC of a single-A, and so forth. As guarantees take their place alongside loans as a financial product, the creditworthiness of issuers will become more and more critical. (In passing, it is astonishing that the Federal Home Loan Bank Board permits the full collateralization of thrift-issued LCs by thrift assets, regardless of the credit of the issuer! This places good assets beyond the reach of the FSLIC, undermining its power to offset the losses arising in a failure.)

Third, expansion -- whether through acquisition or new capital -- depends on credit standing. This is certainly true if the source of funding is term debt or preferred stock. A highly rated company has more debt capacity -- and at lower cost -- than a lesser-rated issuer. To be sure, expansion by the less creditworthy occurs. If, however, we view expansion as an indefinite continuum of acquisition and financing steps, such a race is won only by the financially strong.

Our fourth example of creditworthiness as a competitive factor involves government. The FDIC will probably be successful in its proposal to introduce risk-adjusted deposit insurance as a way of protecting the insurance fund from excess risk. Are they not acting like a creditor? More t the point,

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what will be the competitive effect of the insurance ratings? Roughly one out of eight banks will not only pay a higher effective cost for deposits (because of the higher premiums), but will surely suffer the public stigma of being deemed "above normal risk" by an agency of the Federal Government. The stigmatization will occur because private computers can easily simulate the oversimplified risk analytic methodology the FDIC proposes. Here then is a competitive disadvantage from which many will not survive, given the nervousness of public opinion today about banks.

The Governance of Financial Industry Risk. It is commonplace to assume that bank regulators are the best and the only bulwarks against excessive risk in the banking system. Nothing could be further from the truth. The front line in risk management of the financial industry is the managers of that industry. Weakness here cannot be stemmed by government. The difference between the problems of thrifts and the problems of banks is not due to superior regulation, but rather to factors of management.

This is not to say that managerial discipline is self-sufficient. The example of Continental shows that other bulwarks against risk are needed to guide the wayward back to prudence. Creditworthiness is the best name for this other package of disciplines. The emerging power of the marketplace

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as a discipline on banks is driven by a concern over creditworthiness. The same concern leads the FDIC to protect the insurance fund by basing insurance premiums on risk. The same concern, among others, has led the Fed to limit overdraft privileges for some banks more than others.

The point is that risk governance of the financial industry should be viewed as a partnership in which managements, markets, and regulators play mutually supporting roles. The measure of the effectiveness of this equilibrium is the extent to which creditworthiness is accepted by all three parties as a criterion of excellence.

Seen in this light, the present effort of regulators and Congress to "re-regulate" banks is just bad policy, if not overkill. Banks don't need higher capital, nor do they need limitations on their powers. They need to be managed well enough so that the shifting frontiers of their risk exposure are well patrolled. Public policy that ignores this as its primary goal is blind to what keeps banks safe. That policy is blind too that fails to recognize the importance of managements and markets as crucial partners in the risk control enterprise. Fortunately, the policies of the Reagan Administration are generally favorable to the recognition of these principles.

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What Managements Should Do. A simple inference may be drawn from the argument of this article. It is that creditworthiness sets a theme that ought to run through every aspect of bank risk management, connecting policy and strategy on the one hand with funding power and insurability on the other. Although for many managements this may be an unfamiliar way to think, it is not in the least far-fetched. On the contrary, more and more of the competitiveness of financial institutions will be determined by ease of access to low-cost funding, insurance, or (in the case of guarantees) sheer credit standing.

If this is a correct assessment of this new principle, then it follows that a responsive management will listen to the market and internalize its standards. For those that are already familiar with the process, this will mean little change. For those that are unfamiliar, the first step is what might be termed a "creditworthiness audit". This exercise should take into account not only a comparative ratio analysis against creditworthy peers, but should also evaluate policies, strategy and the status of accounting and control systems. A second step should be to redesign, as necessary, the corporate plan to take into account the higher standards toward which performance should be oriented. The third step is to begin a process of face-to-face liaison with the market, so that appropriate providers or arbiters of credit have a sense of the people and policies behind the numbers. The final step is to integrate all three of the above steps into a single process, so that each phase provides guidance to the others. There is little doubt that the most successful financial institutions already act this way, just as there is little doubt that the walking wounded never learned these lessons. In the future, the market is apt to be even less tolerant than it has been so far.

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FUNDS TRANSFER RISK MANAGEMENT

CREDITWORTHINESS

The following excerpts are taken from the "Creditworthiness" section of Funds Transfer Risk Management, A Guide to Compliance with Federal Reserve Board Policy, published October, 1985 by ABA in cooperation with RMA. David C. Cates is the author of the section.

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FUNDS TRANSFER RISK MANAGEMENT

CREDITWORTHINESS

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APPENDIX A: Risk Profile and Ratio Trails

Table 1: UBPR/BHCPR Sources for Recommended Ratios

Table 2: The Three Case Banks Compared

Table 3: Ratio Presentation Format for Five Years

Table 4: Percentile Display of Key Ratios

Table 5: Credit Rating Grade Display Format

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INTRODUCTION

Purpose of this Section

It is the goal of this section of the Funds Transfer Risk Management manual to explain what creditworthiness means, how it is analyzed, and to document the self-assessment compliance that Federal Reserve policy urges for all banks and requires for institutions incurring overdrafts on Fedwire. The goal is to enable the staff and management of each bank to prepare for its board's discussion and approval a comprehensive, concise, credible and communicable report on that bank's creditworthiness. To accomplish this objective we will also suggest various formats of presentation — illustrated by three case studies — which display a consistency of approach for all banks, while offering latitude for smaller, larger, and unusual banks. A secondary goal is to communicate and illustrate a method of credit analysis which can help in evaluating the credit of counterparty banks.

Other Creditworthiness Audiences

There are likely to be non-regulatory audiences for the creditworthiness self-evaluation reports. The Federal Reserve has assured banks that the file is confidential, yet it is likely that audiences will emerge other than directors and regulators. For one thing, the team preparation of these reports means that a wide cross-section of senior managers will be a part of the development of the material. To the extent that the report captures the true creditworthiness profile of a bank, these managers may want to use the report as a basic document for risk management, marketing, and strategic planning. For many banks, then, the creditworthiness report will function as an informational (i.e., management) tool. Certain external audiences, as they learn of its existence, may also ask to see the report. The bank's legal counsel participating in the self-evaluation project should review the report with this in mind.

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What the Federal Reserve has done is to cause director approved analysis of all the significant risk exposures of a bank and of its capacity to absorb risk. Since there is no reason why the ancillary benefits of this analysis should not be put to use, it is likely that many banks will welcome the opportunity to share edited summaries of their reports internally and externally. The sharing process may even serve to broaden the markets for bank paper and bank insurance, since directors would be perceived as less passive overseers of the risk profile of banks. In addition, many observers believe that the true riskiness of most banks is far less than the public seems currently to accept. To the extent this can be documented, it should help ease the concern that lingers over the entire industry.

The Three Challenges

A management will face three principal challenges in preparing and presenting the creditworthiness self-evaluation to its board. First, it is an unfamiliar, if not unprecedented, action for many managements to take a credit-analytic perspective on themselves, especially at the board level. For those larger banks that regularly present their case, as persuasively as possible, to credit rating agencies and other analysts, the task is now to become that rating agency internally, asking all the hard questions.

Second, there is a challenge in devising a bridge between the intrinsic complexity of bank credit analysis, on the one hand, and board unfamiliarity with analytic method and terminology, on the other. The Federal Reserve has urged discussion by each board, suggesting also that the discussion minutes are to be part of the file for examiner review. To meet this challenge, this manual will emphasize a highly structured and compressed delivery that communicates substance, encourages understanding, and elicits reasoned discussion. It should be noted, however, that the Federal Reserve has indicated that depository institutions can utilize any format they deem appropriate as long as the the analysis is well-documented.

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Third, each management — and the industry collectively — faces the challenge of objectivity. One measure of this challenge is the percentage distribution of final ratings that will emerge among all filing banks. The Federal Reserve has noted that an Association of Reserve City Bankers study suggests that no more than 10%-15% of banks in each major peer group should properly be classified as "excellent" in the Board's current nomenclature. Federal Reserve staff have also suggested that there are just a few "below standard" ratings. Thus 85%-90% of banks will fall into the "very good" and "adequate" categories. If this reasoning approximates the rating structure the Federal Reserve anticipates, then too many self-classifications in favor of "excellent" will not only be viewed as unrealistic, but could threaten the voluntary nature of the Federal Reserve's risk-control policy.

The Relation of This Work to the Federal Reserve Guide

What relation will this section of the Funds Transfer Risk Control manual bear to the Guidebook the Federal Reserve has developed? For one thing, the perspective of the private sector is inevitably different from that of government. One example is the discussion in these pages of the likely audiences for self-evaluation reports. To the extent these audiences emerge, addressing their needs and meeting their standards is a private sector responsibility. The concept of "creditworthiness" implies a market relationship between banks and their funds-providers, virtually all of which occurs in the private sector.

It is also fitting that in a voluntary program there be room for industry self-determination of the methods and styles of compliance. There should also be room for reasoned commentary on Federal Reserve language and guidelines, as well as technical comments on the Uniform Bank Performance Report (UBPR) and the Bank Holding Company Performance Report (BHCPR). Since these are likely to be the basic documents supporting comparative analysis, a look at their design features is useful.

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Finally, though a main goal of this manual is to strive for consistency with Federal Reserve policies, methods and models, this manual will indicate that there exist other sources of data and analytic methodology. For example, the SEC has long mandated disclosure formats for investor-owned bank holding companies (BHCs), formats that are widely studied by funds-providers. Thus, there are market standards of financial analysis that complement regulatory approaches to analysis. It is the goal of this section of the manual to "harmonize" the two.

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METHODS OF BANK CREDITWORTHINESS ANALYSIS

A Definition of Bank Creditworthiness

The only definition of creditworthiness to appear in the Federal Reserve policy statement of May 17 is "the ability of a bank to fund itself rapidly." This ability is important because settlement volume — the risk — must be covered by funding power. Hence the reason for creditworthiness as one of the three criteria of self-evaluation.

Consistent with this view is a fuller definition of creditworthiness as "the perceived ability to repay." Two factors are embedded in this general definition, which is no different for banks that for other types of borrowers. One factor is the actual cash flow reality: the ability to repay. The other factor is the market's perception of that reality. These factors usually point in the same direction, but not always: sometimes the market of creditors overestimates (or underestimates) the true ability to repay.

It is the interplay of these two factors which may help to explain why the Federal Reserve guidelines put one stress on internal, non-comparative factors like the examination report, and another stress on comparative ratio analysis. The latter serves to summarize market perception, and therefore, to discipline the possible upward bias of self-assessment. The former serves to indicate whether the market perception is justified. Both are essential.

A Conceptual Framework for Creditworthiness Self-Evaluation

The opportunity exists, in a self-evaluation, to integrate the two modes of analysis to achieve a powerful result. On the one side lies all the internal data about a bank, its liquidity plan (or cash flow model), its near-term earnings outlook, the credit quality of its assets, and so forth. The examination report and developments since the last examination form a part of this internal data.

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On the other side lies the comparative financial analysis that funds-providers may perform in looking at a bank. Comparative analysis by itself suffers from remoteness and it tends to lack knowledge of the internal facts and policies that lie behind the numbers.

How should the two modes of self-evaluation be integrated? Are they to be viewed as entirely separate, or should one mode include the other? The recommendation of this manual is that comparative analysis should be the framework within which the self-evaluation of creditworthiness occurs. This is for three reasons. First, because the subject matter is complex, the importance of "framework" is overriding, if only as a communications tool. There should be a single, simple framework of analysis and presentation within which a large amount of detail can find its logical place. Second, this framework should be dominated by comparative analysis, since that is the basic method by which the market of funds-providers judges the power of banks to fund themselves rapidly. Within this presentational structure, it is possible to insert internal data at appropriate points. Third, the recommended presentational outline is a "prompt" system that, in effect, asks each complying bank not to leave out anything important, favorable or unfavorable, and provides a place for any and all relevant commentary.

There are four elements that make up this standard outline:

- Delineating a "risk profile" framework of analysis
- Selecting ratios that comparatively illuminate these risks
- Inserting commentary based on internal data and policies
- Testing the analysis with various fail-safe checks

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Funds Transfer Risk Management
Creditworthiness

Element 1: The Risk Profile Framework

It is clear from a reading of the Federal Reserve policy statement that banks are being asked to evaluate their riskiness, not just wire transfer risk, but other risks as well. Riskiness and creditworthiness, in other words, are seen as concepts so closely related as to be virtually identical.

The Federal Reserve statement offers such a framework of risk analysis, for purposes of compliance. Banks are to evaluate their creditworthiness according to these categories: asset quality, earnings, capital, liquidity, and holding company (if any).

This framework, however, does not explicitly provide for other risks of banking which are widely acknowledged, for example, interest-rate risk, control risk, and strategy risk. In the presentations of some banks, these risks, or perhaps others, will find a place. The ensuing discussion, however, does not further develop the notion that there may be models of risk, other than those provided by the Federal Reserve.

Element 2: Documenting Riskiness from a Comparative Standpoint

It is at this point that comparative ratio analysis is drawn upon for the contribution it can make to the overall self-evaluation. The diagnostic power of ratio analysis justifies the emphasis which the Federal Reserve has placed upon it. Comparative analysis, in other words, is an important discipline in the self-evaluation process. At the same time, adequate comparative analysis of banks requires a large number of ratios, and this fact poses an important challenge. The Uniform Bank Performance Report (UBPR), for example, contains hundreds of ratios, and other analytic systems also contain scores of ratios. Among professional analysts, there is general agreement that the fewer the ratios, the less reliable is the analysis. The reason, of course, is that any one ratio — whether ROA, net charge-offs to loans, or capital to assets — is by itself potentially misleading. Only in context of other ratios does the significance of each ratio take shape. The wider the context, the more meaning.

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This notion of the interdependence of ratios is one justification for a general set of guidelines for analysis, as provided by the Federal Reserve policy, rather than a specific cookbook approach which the Federal Reserve specifically rejected. The latter would tend to relieve bank directors from their responsibility to apply judgment. An exception to this general rather than specific approach is that adjusted primary capital must be at least 5.5 percent of total assets.

A good way to organize this comparative material is to program the analysis in advance. That is, the ratios should be sequenced in such a way that they not only cover all aspects of the analytic task, but prompt a correct interpretation as well. The name "ratio trail" (synonymously, "analysis trail") can be given to this process, since it resembles in concept the "audit trail" used by accountants and auditors.

A ratio trail can be constructed to illuminate each of the categories in a bank's risk profile. This will be outlined in detail later. Also, three case analyses will be presented which show these analysis trails in action.

A ratio trail, if properly constructed and interpreted, has two important characteristics. One characteristic is that a "trail" is also a "cluster," so that many individual ratios function together as a single, if complex, signal. To illustrate, many banks reveal sound asset quality through a cluster of ratios that show (among other things) low net charge-offs, high recoveries, low non-performing loans, and adequate reserves. Since the cluster always has more significance than any single ratio, users can more easily understand the issues.

The other characteristic of a ratio trail is that it encourages "analysis by exception." This means that the ratios deserving special comment are those that behave very differently from peer norms. For example, say that all the ratios of a bank appear reasonable, except that loans are growing at a rate of 50% per year, and that large-dollar liabilities are a high fraction of assets and also growing rapidly. These exceptional facts flow color our view about the entire analysis. Analysis by exception, therefore, makes it possible to scan scores of ratios to find those which are significantly out of

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line with peer group norms. The disparity may be fully justified, but the questions need to be asked. By the same token, normal or superior ratios require less attention. In the case presentations later in this section, most of the ratios shown in the tabular formats are not discussed at all. They are there for completeness and to indicate their normality. To show many ratios, with or without discussion is, in other words, a form of due diligence.

It is important also to note that each piece of the risk analysis is a sub-assembly of the whole. Thus liquidity risk cannot be analyzed separately from earnings behavior and capital adequacy.

Element 3: Facts and Policies Behind the Numbers

Ratio analysis is powerful but incomplete. Though unlikely, even the "strongest" ratio picture could be misleading. More to the point, a "weak" ratio picture may have redeeming features that only inside knowledge can illuminate. Thus a self-evaluation, to be complete, must contain commentary about facts, policies, plans and outlook that are not captured in external financial reporting. The larger and more complex the bank, the more commentary is probably required.

The analysis of liquidity in a larger bank, for example, is incomplete without discussion of funding strategy, large-dollar funding sources, funding capacity, capacity testing procedures, breakdowns by maturity and size, etc. Earnings self-analysis is incomplete without discussion of loan loss outlook, reserving policy, revenue strategies, expense control targets, and income tax provisioning.

Capital analysis, especially in a larger bank, needs discussion of growth strategy and capital plans, the capital implication of off-balance-sheet risk, the riskiness of assets, access to long-term debt and equity financial markets, and dividend policy. For banks that are members of bank holding companies, much of this discussion belongs in the holding company section of the evaluation. Finally, commentary based on the examination report should be inserted at appropriate points.

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Funds Transfer Risk Management
Creditworthiness

Element 4: Fail-Safe Checks

In describing the kind of analysis and discussion it wants to see, the Federal Reserve has used words like "objective," "balanced," "realistic," "serious," and "diligent." This language, of course, also describes any good credit analysis.

What checks are available to impose on the analysis and conclusions flowing from staff preparation to board presentation? Put another way, what answers might a board want in order to assure itself of analytic objectivity?

One of these is a presentation (see Table 4 of Appendix A) of the bank's percentile standing within an appropriate UBPR/BHCPR peer group. A very similar check, suitable for larger banks, is to present the bank/BHC standing within a rating grade peer group such as "Moody's P-1 Regionals Over $5 Billion of Assets" (see Table 5 of Appendix A, see also Case A). A third check on objectivity, of course, is to review the self-analysis in the light of the most recent examination report.

Still another fail-safe check is provided by whatever system a bank uses to evaluate the credit of counterparty banks. Where would this bank stand if measured against that system?

These checks are not meant to dictate the outcome of the self-evaluation, but only serve as a guide or challenge in the preparation of the analysis report, as well as the board discussion thereof.

The four elements described above will produce a risk profile — creditworthiness self-evaluation — in which comparative analysis interacts with facts, policies, plans and outlook, all disciplined by one or more fail-safe checks. Performed with skill, the resulting analysis can be far more powerful than any examination report or other outsider analysis can ever be.

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CASE A: LARGER REGIONAL BANK

PERCENTILE DISPLAY OF KEY RATIOS

	Peer Mean	Bank	Percentile (1): 0 10 20 30 40 50 60 70 80 90 99
BANK			
* Net Losses to Loans	0.46%	0.10%	
Recoveries to Prior Period Loss	25.05	42.64	
* Non-Performing Loans to Loans	2.81	1.34	
Loss Reserve to Total Loans	1.30	1.19	
ROA	0.76	1.20	
Net Interest Margin	4.38	5.50	
Non-Int Inc to Avg Assets	1.24	1.80	
* Overhead to Oper Inc	63.94	61.50	
* Loss Prov to Avg Assets	0.44	0.23	
Primary Cap to Assets	6.33	6.26	
Capital Formation Rate	8.87	10.85	
* Volatile Liability Dependence	30.83	34.03	
Core Deposit Growth	13.59	16.43	
CONSOLIDATED BHC			
ROA	0.81%	1.15%	
Net Interest Margin	4.91	6.25	
* Net Losses to Loans	0.53	0.37	
Allow for Ln Losses to Tot Lns	1.31	1.28	
* Volatile Liability Dependence	23.86	25.58	
Primary Capital to Assets	6.79	7.30	

(1) In the above scale, the stronger/more favorable the ratio, the closer the percentile value to 99. Conversely, the weaker/less favorable the ratio, the closer the percentile value to 0. Where noted (*) UBPR percentiles have been converted to conform to this scale.

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CASE A: LARGER REGIONAL BANK

PERCENTILE DISPLAY OF KEY RATIOS (Con't)

	Peer Mean	Bank	Percentile 0 10 20 30 40 50 60 70 80 90 99
PARENT			
* Liabilities to Equity	42.59%	11.61%	X
Fixed Charge Coverage	271.32	707.46	X
Cash Flow Match	117.16	99.57	X
* Double Leverage	105.75	102.39	X
(2) MARKET			
P/E Multiple	8.02x	7.42x	X
Dividend Yield	4.18%	4.21%	X
Market Price to Book Value	104.43	124.93	X

(2) Figures from private sector data source.

KEEFE, BRUYETTE & WOODS, INC.

ANSWERS TO SENATOR GARN'S

QUESTIONS OF JULY 23, 1985

Q. 1. Should a federal insurance agency be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed institution with any profit after administrative costs arising from the transaction returned to the original stockholders?

A. 1. Apart from the obvious negative impact on all parties from the certain litigation involving shareholder rights in situations involving "ailing but not failing" institutions, the widespread (I assume) use of such a procedure would most certainly disrupt capital flows from the outside to those institutions most in need.

Q. 2. If the burden of mismanagement were placed squarely on the managers and stockholders and most failures were handled through a purchase and assumption at an earlier stage - immediately or through a conservatorship - regardless of size - wouldn't this dispose of the fairness question as it relates to large and small institutions? Why couldn't Continental type solution be applied to failing small banks? If an insurance agency is funded totally by institutions is there a federal subsidy?

A. 2. This question appears to be #1 in different form. The history of repeat employment (or non-employment) of senior management of failed banks in the last decade would indicate that, in fact, responsiblity has been placed squarely on managers; shareholders of failed banks have been financially disenfranchised as well.

A Continental type solution for all failed banks would require that the insuring agencies devote more and more of their scarce resources for managing a growing portfolio of non performing assets. The cost-benefit to the agencies of applying Continental - type solutions to small banks is clearly unrewarding.

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There is no explicit subsidy when the insuring institution is completely funded by the insured banks. However there is an implicit subsidy which exists because it is well understood by all players that the resources of all concernsd federal agencies (Fed, Treasury) are available for maintenance of the security of the depository system.

Q. 3. What can be done to prevent covenants in subordinated debt agreements from requiring the FDIC to prevent losses to all creditors as well as the holding company?

A. 3. To the best of my knowledge and that of my firm this is not a problem, however we find the question difficult to interpret.

Q. 4. Should CPA audits be required of all depository institutions and their holding companies? What steps, if any, should be taken that would permit federal bank examiners to place more reliance on auditors' evaluation of management systems and controls? Would this help examiners focus on asset quality, and bank risk levels, etc.?

A. 4. Auditors don't make loans and cannot be expected to substitute for regulatory credit oversight. Small bank failures are also not the cause for the current level of concern about the financial industry or the regulatory process. I do agree that the scope of federal examination ought to be streamlined to focus on the left hand side of the balance sheet and on appropriate disclosure of the quality of that side so as to permit funds providers to make effective and timely decisions about giving to and taking from the right hand side of the balance sheet.

Q. 5. What is your view of permitting federal regulators to require institutions to pay special assessments for the increased examinations made necessary by their classification as a problem institution?

A. 5. It may be appropriate to charge where costs are incurred; it is hardly the nub of the problem.

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Q. 6. If regulators are rarely suprised by a bank failure - isn't the answer swifter or more appropriate regulatory action rather than increased market discipline? Wouldn't giving the regulators the ability to close an institution earlier be appropriate? Should a regulator require bank management to file a confidential bank failure plan approved by its board of directors if it falls a certain percentage below its minimum capital level for a specified period of time?

A. 6. Regulators are seldom surprised by failure; they are surprised to encounter rapid increases in loans, and in nonperforming loans, that may be too late to correct and that may in turn lead to failure.

WHY NOT A REPORTING TRIGGER? REQUIRE A BANK TO REPORT IN TO THE REGULATOR EVERY TIME TOTAL ASSETS, OR LOANS, (OR OFF-BALANCE SHEET ITEMS, PERHAPS) INCREASE BY 10% (OR SOME APPROPRIATE NUMBER) OVER A BASE PERIOD. UNDER THIS SORT OF SITUATION, REGULATORS HAVE A CONTINUOUS MONITORING SYSTEM RATHER THAN HAVING TO WAIT 18 MONTHS. BANKS CAN GO BAD QUICKLY.

Bank failure plans sound silly.

Q. 7. There appears to be strong support for required risk-based capital - as a method of calculation of capital or as a supplement to the flat rate capital ratios. Would this necessarily lead to higher capital standards? Is there any need for legislation in this area if such risk-based standards were to be applied equally to all institutions?

A. 7. Risk-based determination is an incredibly complex problem that, frankly, is beyond the scope of any person or group of persons with whom I am familiar. In fact, simplification is necessary in the dual form of restraint and disclosure -restraint in the sense of a streamlined examination process concentrating on growth monitoring and asset quality (see # 6 above) combined with adequate and timely disclosure of condition to allow markets to function.

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Risk-based capital (and the attendant demand to increase capital - usually impossible by definition) is just another way of saying "no" to continued growth. Once a bank is determined to be badly managed or in danger, why not just say "no?" The markets do, and the regulators have the power as well.

We are not qualified to comment upon the need for legislation.

Q. 8. In 1981 and 1982, the banks and thrifts were suffering from disintermediation - their better customers were flocking to money market funds in droves. Now the concern seems to be that the higher quality loan customers are able to fill their needs elsewhere. The banks point to commercial paper, and the securitization of their loan portfolio. They claim that this trend is being caused in part by their capital ratios and reserve requirements. What is your view? What recommendations do you have for us in this area?

A. 8. The banks are wrong. This trend is caused by the freeing up of the markets, in 1974 and even more so in 1979. Banks simply could not compete any more on a price basis for the best customers. That fact has been accepted too often and too clearly to be contradicted by anyone other than the shortsighted. It is a known fact that blue-chip corporate customers left the banks in droves during the 1970s, at precisely the time that bank capital ratios were declining rather than improving.

The disintermediation and securitization of loan portfolios is part and parcel of an evolving and maturing financial system.

There is only one recommendation that makes sense: demand quality of banks and the ratios will fall in place.

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Q. 9. Mr. Isaac has stated that a significant number of bank failures are caused by fraud other than increased enforcement actions which are being taken by the federal agencies - aren't Mr. Homan (Former Senior Deputy Comptroller for Bank Supervision, Office of the Comptroller of the Currency) and Mr. Ryan (Former Director, Division of Banking Supervision and Regulation, Federal Reserve System) right as to the importance of the ON-SITE exam to ascertain the integrity of the numbers being generated and the lack of fraud? If so, does the decrease in on-site examinations bring with it an increase in the risk of fraud? If so, how can this be corrected?

A. 9. Fraud in the banking industry - with a few notable exceptions such as the Butcher situation - is a non-event in the current context. As to on site inspections and their effectiveness in countering or stopping fraud, I have no supportive information but common sense suggest agreement with the notion.

Q. 10. In your opinion, what are the advantages and the disadvantages of risk-based capital and risk-based premiums? Should we consider one or the other or both? Why?

A. 10. There is a tone to the questions in the aggregate that implies increasing frustration with and skepticism about the federal regulatory examination process. If so, this notion makes the idea of accurate risk determination even more questionable than previously thought.

However, the current method of determining insurance premiums and capital ratios has the implicit assumption that all banks and assets are equally risky. This assumption is palpably ludicrous.

The process, and responsiblity, for assuring a sound financial system depends on prudent management, bulwarked and nudged by the joint effort of regulators their efforts on left hand or asset side of the balance sheet with the marketplace disciplining (with the help of adequate disclosure) the right hand side of the balance sheet.

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN

CONTINENTAL BANK

CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY OF CHICAGO • 231 SOUTH LA SALLE STREET • CHICAGO, ILLINOIS 60697

PAUL M. HOWARD
EXECUTIVE VICE PRESIDENT

October 10, 1985

1. Should a federal insurance agency be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed institution with any profit after administrative costs arising from the transaction returned to the original stockholders?

No. Generally, managed purchase and assumption transactions or mergers should be arranged after insolvency occurs, not before. To date the FDIC has used this method very effectively with minimum disruption to the banking system and individual customers, depositors, creditors and shareholders of failed institutions. Changing such a policy along the lines described would unnecessarily infringe on the rights of bank shareholders. Determining economic insolvency based on net worth or liquidity measures generally is an objective exercise with only some subjectivity involved. Such measures reduce the possibility of error or of arbitrary and capricious behavior by the federal regulatory and insurance agencies. On the other hand, moving to different and necessarily more subjective criteria to determine whether the federal insurance agency should purchase control prior to insolvency exposes the system to unnecessary government interference in a private enterprise.

I do believe, however, that the federal regulatory agencies should be allowed to force mergers, should financial institutions, after due notice, fail to comply with reasonable capital requirements imposed by the regulators.

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2. If the burden of mismanagement were placed squarely on the managers and stockholders and most failures were handled through a purchase and assumption at an earlier stage - immediately or through a conservatorship - regardless of size - wouldn't this dispose of the fairness question as it relates to large and small institutions? Why couldn't a Continental-type solution be applied to failing small banks? If an insurance agency is funded totally by institutions, is there a federal subsidy?

If federally assisted purchase and assumption transactions were conducted immediately after or before failure or through a conservatorship and if this were done consistently for all sizes of institutions, the fairness question would be resolved.

The keys to the fairness question rest not only in reasonably equal treatment to large and small failure situations but in the treatment of managers, directors and shareholders as well.

In banking an economic failure generally occurs when the financial institution is declared insolvent and the FDIC is appointed receiver. It can also occur, as in Continental, when a federally assisted solution is found which is short of a declared insolvency. In both cases the FDIC can and does insist that:

- stockholders lose their investment
- responsible managers and directors are fired

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Thus, if a so-called federal "bailout" occurs, it is not the shareholders or managers who are being "bailed out." There is also no question that a "failure" occurs in both cases.

I believe that the traditional purchase and assumption transaction or a Continental-type solution should be applied in every case, large or small. While some might call this 100% deposit insurance, so be it. To date the insurance funds have been more than adequate to cover all losses with minimum disruption to the banking system and the public's confidence in it.

Moreover, the federal insurance funds are provided by premiums paid by financial institutions, a direct tax. In addition, financial institutions bear the costs of heavy regulation and oversight by the government. Given these costs and burdens it is hard to come to a conclusion that the banking system is somehow being provided a federal subsidy when an occasional FDIC assisted transaction takes place.

In sum, FDIC assisted transactions of the types used extensively since 1973 should continue to be used. The cost to the insurance funds has been a small price to pay for a safe and sound banking system which continues to command the public's confidence.

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3. What can be done to prevent covenants in subordinated debt agreements from requiring the FDIC to prevent losses to all creditors as well as the holding company?

The market determines the covenants in subordinated debt agreements. The government should continue to allow the market to set the terms, notwithstanding the FDIC's risk.

4. Is there a place for self-regulation in the banking industry that draws on the talent within the industry? If so, how could concepts of self-regulation be included in the federal supervisory system?

While there may be a place for self-regulation in the banking industry, there does not appear to be a place for the type of peer reviews which have worked in other industries, notably the accounting industry. Banking participants are too diverse and too many for self-regulation to be effective. Continued education and strong enforcement of the laws are better alternatives.

5. What is your view of Mr. Keefe's suggestions that

   a. The current loan limit is too high?
   b. Many banks fail due to excessive concentration?
   c. A bank be required to list its 30 largest borrowers by type of company?
   d. The largest banks be required to supply regulators with monthly data?

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Mr. Keefe has made many helpful suggestions. But most banks fail due to bad management and bad judgement and not because the loan limits are too high. The loan limits of national banks are on a reasonable parity with state systems and should be kept where they are.

In my sixteen years with OCC, I was never aware of even one bank to fail because the lending limit was too high. However, banks have failed when they have violated the lending limits and made excessive loans with large loss potential. In these cases the problems were centered in lenders, not lending limits.

I agree with Mr. Keefe that banks should diversify as much as possible and avoid excess concentration. But, again, good management and good judgment can control excess concentration when such concentration is unavoidable, such as in rural America.

As to Mr. Keefe's suggestions on disclosure, I believe the regulators should concentrate on getting quality data, not more data. I have suggested several ways this could be accomplished in my testimony, notably through more on-site examinations and by requiring CPA audits.

6. Should CPA audits be required of all depository institutions and their holding companies? What steps, if any, should be taken that would permit federal bank examiners to place more reliance on auditors' evaluation of management systems and controls? Would this help examiners focus on asset quality, and bank risk levels, etc.?

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I believe CPA audits should be required of all depository institutions and their holding companies for reasons suggested in my testimony, a copy of which is enclosed.

7. Would you recommend that federal depository agency personnel be exempted from government pay ceilings? If so, how can this be effectuated?

The greatest contribution the Congress could make to improved bank supervision would be to exempt the federal bank and thrift regulators from government pay ceilings. I have discussed the reasons supporting this opinion at length in my testimony. There are various laws and administrative procedures in the Executive Branch which would need to be changed to accomplish this initiative. More important, perhaps, politically appointed agency heads would have to be encouraged to depart from custom and practice to effect an appropriate pay scale. It will take courage on their part, for such actions are sure to be resisted by entrenched bureaucracies at OMB, OPM and the U. S. Treasury.

8. What is your view of permitting federal regulators to require institutions to pay special assessments for the increased examinations made necessary by their classification as a problem institution?

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I support the notion of having special assessments for increased examinations and, I would add, increased supervision of problem institutions. This is a much more practical way of having such institutions pay for the increased risk they present for the system than the various risk-related deposit insurance schemes which have been proposed to date.

9. If regulators are rarely surprised by a bank failure - isn't the answer swifter or more appropriate regulatory action rather than increased market discipline? Wouldn't giving the regulators the ability to close an institution earlier be appropriate? Should a regulator require bank management to file a confidential bank failure plan approved by its board of directors if it falls a certain percentage below its minimum capital level for a specified period of time?

For reasons stated in my testimony, I agree that swifter or more appropriate regulatory action, rather than increased financial disclosure, is the preferred method to discipline banks. However, I believe the regulators have all the powers they need to deal effectively with problem bank situations, with one exception. To better enforce capital requirements, the agencies should have the power to require a merger before a book insolvency occurs, but only after other methods to raise capital have been exhausted and due notice has been given.

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To assure the willingness and the ability to take swifter or more appropriate regulatory action, the agencies need to be able to attract and retain more experienced, better trained and highly talented professional examiners and supervisors. Again, lifting present pay scales would be a start in the right direction.

10. What percent of total bank earnings are paid in deposit insurance premiums each year? Has this percentage gone up or down over time? Is there much variance bank to bank or by size of institution?

I will defer to the FDIC on Question 10.

11. There appears to be strong support for required risk-based capital - as a method of calculation of capital or as a supplement to the flat rate capital ratios. Would this necessarily lead to higher capital standards? Is there any need for legislation in this area if such risk-based standards were to be applied equally to all institutions?

Risk-based capital standards are appealing in concept but are difficult to apply practically. Furthermore, much more subjectivity is required than for simple capital ratios. Therefore, such standards are more error prone and arbitrary and may not be universally applicable to all banks. For these reasons,

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risk-based capital standards should be used as supplements to the simple capital standards until more experience with them is gained. Such standards should also be flexible enough to accommodate appropriate exceptions.

Because all capital standards may have to be modified to accommodate changing circumstances or may have to be changed based on experience with their use, such standards should be set by the federal banking regulators and not through legislation.

12. In 1981 and 1982, the banks and thrifts were suffering from disintermediation - their better customers were flocking to money market funds in droves. Now the concern seems to be that the higher quality loan customers are able to fill their needs elsewhere. The banks point to commercial paper, and the securitization of their loan portfolio. They claim that this trend is being caused in part by their capital ratios and reserve requirements. What is your view? What recommendations do you have for us in this area?

. The causes of bank and thrift disintermediation are well known and are market driven. The unregulated or less regulated financial service institutions are currently enjoying many competitive advantages over banks. As only one example, high capital ratios for banks certainly places them at a severe competitive disadvantage vs. thrifts and the securities industry.

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Fairer treatment on capital ratios, however, is only one factor in the competitive equation affecting financial institutions. Banks simply must be given more latitude in the products they can offer and in where they can conduct business. Until the product and geographical boundaries are redefined, banks and thrifts will remain at a competitive disadvantage.

13. With regard to the concern that some states may have expanded banks product authorities beyond what may be prudent, can this issue be dealt with by giving the federal insurance agencies the authority to require a prudent level of capital to support that activity in order to maintain insurance - rather than giving any federal agency the authority to override a state legislature? In other words, wouldn't the adoption of risk-based capital standards go a long way toward solving this problem?

I do not believe the evidence to date suggests that expanded bank products authorized in some states is a cause for extreme concern. Even if such evidence mounts, it is the Congress which should deal with the issues, not the federal insurance agencies. The federal insurance agencies will usually opt for the most restrictive requirements necessary to protect the insurance funds. This bias may not always result in the best public policy.

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14. Mr. Isaac has stated that a significant number of bank failures are caused by fraud other than increased enforcement actions which are being taken by the federal agencies - aren't Mr. Homan (Former Senior Deputy Comptroller for Bank Supervision, Office of the Comptroller of the Currency) and Mr. Ryan (Former Director, Division of Banking Supervision and Regulation, Federal Reserve System) right as to the important of the ON-SITE exam to ascertain the integrity of the numbers being generated and the lack of fraud? If so, does the decrease in on-site examinations bring with it an increase in the risk of fraud? If so, how can this be corrected?

Please refer to my testimony for my complete views on this subject.

15. Even though the FDIC continues to grow, how can or should we determine if the size of an insurance fund is sufficient and will continue to be sufficient

I defer to the FDIC on this question.

16. In your opinion, what are the advantages and the disadvantages of risk-based capital and risk-based premiums? Should we consider one or the other or both? Why?

For reasons stated above, risk-based capital standards should be approached cautiously because they are more subjective and more arbitrary than traditional measures. Risk-based deposit premiums may not be practical and should be abandoned in favor of having problem banks pay for the increased examination and supervision they require from the federal regulatory agencies.

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Responses to Questions
posed in September 25, 1985 letter
from Chairman Garn

DEPOSIT INSURANCE REFORM

John E. Ryan
Bank and Financial Consultant
Arky, Freed, Stearns, Watson
Greer & Weaver, P. A.
Suite 2800
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Miami, Florida 33131

Question:

1. Should a federal insurance agency be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed institution with any profit after administrative costs arising from the transaction returned to the original stockholders?

Answer: Insolvency presumes that the private stockholders' interest has been wiped out. To seize the institution prior to that point could be viewed as the equivalent of confiscating private property. The fact that any profit to be realized from merger with a healthy institution goes to the seized institution's shareholders would seem to offer little recompense because profit, under the circumstances, is likely to be minimal or nonexistent. In order to protect the private property interest of the shareholders, therefore, it would probably be necessary to establish criteria for such seizures that are very close to insolvency, thereby, negating much of the perceived benefit from earlier action by the insurance agency. To do otherwise could create a considerable disincentive for investors to purchase bank stock causing a capital shortage for the banking system, the adverse effects of which could far outweigh the benefits of quicker action in troubled bank situations. I would, therefore, leave the insolvency criterion in place.

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Question:

2. If the burden of mismanagement were placed squarely on the managers and stockholders and most failures were handled through a purchase and assumption at an earlier stage -- immediately or through a conservatorship -- regardless of size -- wouldn't this dispose of the fairness question as it relates to large and small institutions? Why couldn't a Continental type solution be applied to failing small banks? If an insurance agency is funded totally by institutions is there a federal subsidy?

Answer: The burden of mismanagement is placed squarely on managers and stockholders under present procedures because in a failed bank situation the stockholders lose their investment and the responsible managers lose their jobs and remain culpable for their actions.

A purchase and assumption transaction for all institutions, regardless of size, would help address the fairness question as it relates to possible differing treatment accorded large vs. small institutions. However, the practicalities of each situation are quite different making it impossible to treat every failing bank exactly the same. For example, in the case of a multi-billion dollar institution, the incremental funding requirements for the potential acquisition partner and the possible adverse effect on its own funding capabilities make the acquisition extremely risky even for the largest institutions. In such circumstances, the most prudent course may be an assistance

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program designed to allow the institution to recover while standing alone. Where these considerations are not present, as in most smaller bank cases, the most efficient method of dealing with the problem may be a purchase and assumption transaction. These necessary differences in treatment, however, inevitably raise fairness issues. It is far more preferable to address these issues by requiring that the Agencies, to the extent practicable, extract substantially similar costs and convey substantially similar benefits regardless of which method is used. The flexibility of the insurance agency to use the best method to deal with particular problems is thus preserved.

The fact that the Federally sponsored insurance agencies are funded by the insured institutions themselves is not sufficient to remove totally the specter of Federal subsidy. The credibility of the deposit insurance system is due in substantial part to public perception that the "Government" stands behind it. Without this perception, the insurance funds would probably need to be substantially larger than they are which would increase the cost of insurance for the institutions. A Federal subsidy does, therefore, exist and requires that the insurance agency conduct its affairs in accordance with law and in the public interest more generally.

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Question:

3. What can be done to prevent covenants in subordinated debt agreements from requiring the FDIC to prevent losses to all creditors as well as the holding company?

Answer: I am not aware of any covenants that specifically require the FDIC to prevent losses to all creditors as well as the holding company. It is customary, however, that the indentures of debt obligations of bank holding companies contain covenants that prohibit the holding company from diluting its ownership in or disposing of its principal asset, i.e., the stock ownership interest in its bank, without the prior approval of the debt holders. The practical effect of such covenants, which are quite essential from the perspective of the debt holder, is to bar the subsidiary bank from issuing stock to the FDIC or any person other than its parent company and affiliates without creating an event of default. 1/ The FDIC, in order to put equity capital into the bank where there is a holding company with such indentures, must do so through the holding company.

1/ Of course, the FDIC could probably cause the bank to issue the stock in violation of the covenants and put the bank holding company debt issues in default. Such a default, however, could cause dislocations in the debt markets generally and could undermine the chances of survival of the bank because often the institutions supplying deposits and other funds to the bank are large holders of these debt issues.

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An equity investment by the FDIC at the holding company level, however, has the practical effect of bailing out the bank holding company creditors. This situation could be technically remedied by a regulatory requirement, as a precondition for future debt issues, that all such covenants contain a specific exclusion for stock issued to the FDIC. It is not clear, however, what the effect of such an exclusion would be on the ratings assigned by the major rating services and on the ability of holding companies to sell new debt and refund maturing issues. Judgments as to whether such changes ought to be mandated should be reserved pending a clearer indication of the probable market reaction to them.

Question:

4. Is there a place for self-regulation in the banking industry that draws on the talent within the industry? If so, how could concepts of self-regulation be included in the federal supervisory system?

Answer: Much more could be done by the industry to promote self-regulation, particularly with regard to the establishment of industry-wide standards in such areas as audit and internal controls, loan documentation, and codes of conduct including limits on insider dealings and director responsibilities. It should be noted that trade associations do provide guidance, training and other forms of extremely beneficial

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assistance in these and other areas. Consideration should be given to going further than this, perhaps even mandating minimum standards with violations subject to industry-imposed sanctions.

Given the highly competitive nature of banking with its intense institutional rivalries, it is probably not feasible to use teams comprised of personnel from various banks for the purpose of performing on-site reviews of individual institutions. Instead, examiners for the regulatory agencies and CPA auditors could review compliance with industry standards and possibly make public continuing or eggregious violations of them.

Question:

5. What is your view of Mr. Keefe's suggestions that

   a. the current loan limit is too high?

   b. many banks fail due to excessive concentration?

   c. a bank be required to list its 30 largest borrowers by type of company?

   d. the largest banks be required to supply regulators with monthly data?

Answer: a. The present loan limit is too high and Mr. Keefe is quite correct in his observation that prudent institutions establish "house limits" that are much lower

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than the statutory limit. The previous basic lending limit of 10 percent of capital and surplus to one borrower required greater diversification of risk. Moreover, this level of lending authority coupled with access to participation arrangements with other banks was sufficient in most cases to allow the banks to meet the credit needs of their borrowers.

b. Excessive concentrations of credit to a particular borrower or group of related borrowers and excessive concentrations of credit to a particular industry are clearly sources of severe problems for a number of troubled banks and were among the causes of the failures of others. Generalizations about concentrations, particularly industry concentrations, can lead to quite inaccurate conclusions, however. It is not uncommon, for example, to find among a large number of banks with heavy concentrations of credit to a particular troubled industry only a few problem banks. There are many factors that account for the difference in the quality of the portfolios of these institutions such as the nature of the customer base and the underwriting standards employed; therefore, concentrations, per se, may not be the only problem. What is clear with respect to industry concentrations is that weak underwriting standards

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based on speculative or unreasonable economic expectations will quickly surface when the industry encounters problems.

c. Banks should not be required to list their 30 largest borrowers by type of company. There are many factors such as collateral security and financial strength of the borrower that account for the quality of individual loans. To list the loans by industry invites the oftentimes erroneous conclusion that all loans to a troubled industry are inherently bad or weak. This could shut off new credit essential to the recovery and longer-term health of those industries.

d. The largest banks should be required to supply the regulators with as much information as they may reasonably need. As I mentioned in my testimony, the Paperwork Reduction Act combined with the procedures followed by the Agencies themselves have made it nearly impossible for them to obtain current information on emerging banking practices within a reasonable period of time. Changes in the clearance procedures with the Office of Management and Budget required by the Paperwork Reduction Act and in the Agency procedures themselves need to be made. The Agencies should continue to be held accountable, however, and would need to be able to justify, perhaps on an after-the-fact basis, any significant data requests that result in substantial costs and burden to the industry.

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Question:

6. Should CPA audits be required on all depository institutions and their holding companies? What steps, if any, should be taken that would permit federal bank examiners to place more reliance on auditors' evaluation of management systems and controls? Would this help examiners focus on asset quality, and bank risk levels, etc.?

Answer: All major banking organizations are already required in one way or another to have CPA audits. Some smaller banks and "shell" holding companies have maintained that the costs of audits are prohibitively high and the benefits to be derived are not commensurate with those costs. I am not persuaded by these arguments and believe CPA audits need to be viewed as a fundamental cost of doing business as an insured depository or bank holding company. CPA audits, in accordance with generally accepted accounting practices, should be mandatory for all banking organizations. Some phase-in period for the smaller entities not now required to have CPA audits would help in the transition to a fully audited system.

Bank examiners already base the scope of their examinations on their view of the adequacy and depth of both the external audit as well as the internal audit function. As mentioned earlier, the establishment of minimum industry-wide audit and control standards would be helpful.

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It should be noted that the examiners' focus on asset quality and bank risk levels has been diverted to a substantial degree by added responsibilities heaped on them over the past several years. Such responsibilities, not directly related to safety and soundness, include consumer protection, community reinvestment, currency reporting, etc. Moreover, these added responsibilities have had to be absorbed largely without commensurate increases in resources. The Congress and the Agencies themselves, before adding any new responsibilities to the bank examination function, need to be more mindful of the effect of such additions on the ability of the examination staff to fulfill its fundamental mission.

Question:

7. Would you recommend that federal depository agency personnel be exempted from government pay ceilings? If so, how can this be effectuated?

Answer: In order for the supervisory agencies to retain competent examination cadre, they need to be reasonably competitive with the compensation available to comparable personnel in the private banking sector. It must be recognized, however, that a number of factors influence personnel to move from the Agencies to the private banks and Government service will never be fully competitive in

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terms of monetary compensation with private industry. In any event, when Agency pay scales are far out of line with the pay available in the banking industry for comparable skills and conditions are such that employment opportunities exist, the turnover rate among supervision staffs tends to be prohibitively high. Some flexibility to adjust pay scales in these circumstances is needed even if it means exceeding Government pay ceilings. There does, of course, need to be some control mechanism in place, perhaps a salary advisory board comprised of personnel officers from commerical banks with reporting responsibilities to the Congress could be considered.

Question:

8. What is your view of permitting federal regulators to require institutions to pay special assessments for the increased examinations made necessary by their classification as a problem institution?

Answer: Federal Agencies should not require special assessments from problem institutions to cover the increased Agency costs associated with their supervision nor should they be required to give rebates to good banks that require less supervision. The overall cost of supervising the National banking system should be borne collectively by the National banks with the costs assessed on objective and easily understood criteria such as the size of the

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institution. A complex system that requires attribution of specific costs to specific institutions could get hopelessly bogged down and result in constant haggling over the fairness of the assessment. Scarce Agency resources could be used more productively. Moreover, a special assessment for problem banks, increasing operating costs when they can ill afford to pay, could prove counter productive to their recovery.

Question:

9. If regulators are rarely surprised by a bank failure -- isn't the answer swifter or more appropriate regulatory action rather than increased market discipline? Wouldn't giving the regulators the ability to close an institution earlier be appropriate? Should a regulator require bank management to file a confidential bank failure plan approved by its board of directors if it falls a certain percentage below its minimum capital level for a specified period of time?

Answer: With respect to market discipline, there is little doubt that the markets recognize institutions as being in difficulty when their problems surface in operating results and elsewhere. However, past experience indicates that during the periods of rapid growth, while the commitments that eventually led to the downfall of some of the larger institutions were being made, the markets provided positive reinforcement by bidding up the value of the shares of these aggressive institutions. The supervisor looking at the

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quality of the individual loans as they are being made and reviewing policies and controls is in the unique position to assess whether these aggressive strategies are being executed in a sound manner.

The regulators point out that they don't wait until a bank is in critical condition before taking action and that their policies call for written agreements or cease and desist orders on all banks rated CAMEL 3 or worse. This policy, which I personally helped formulate, has helped prevent deterioration in the condition of a number of problem institutions and has helped turn a number of them around. However, more forceful action at the time loans and commitments are being made before the institution reaches "problem" status is needed.

A review of some of the recent dramatic cases of failing institutions reveals that deficiencies in underwriting standards and unreasonable or highly speculative economic assumptions, coupled with undue concentrations in particular facets of industries, were present in portfolios that went sour when economic conditions changed. By the time some of these institutions were put under supervisory agreements, it was too late to turn them around. Even though few new loans or commitments were being made under the supervisory constraints, the quality of their existing portfolios

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worsened to the point where they failed or had to be assisted. As I indicated in my written testimony, a closer review of the lending function with an emphasis on spotting lending weaknesses before the loans actually go bad and, then, forcefully challenging the underlying strategy with a view toward limiting the risks or correcting the deficiencies would improve supervisor performance.

A confidential bank failure plan filed by the board of directors would probably be of very little use. Prior to failure, the board of directors usually exhaust available alternatives such as finding merger partners or new investors willing to put capital into the institution. By the time the bank has to be closed, its disposition is out of the hands of the board of directors and depends on the action of the insurance agency.

Question:

10. What percent of total bank earnings are paid in deposit insurance premiums each year? Has this percentage gone up or down over time? Is there much variance bank to bank or by size of institution?

Answer: Data are unavailable.

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Question:

11. There appears to be strong support for required risk-based capital -- as a method of calculation of capital or as a supplement to the flat rate capital ratios. Would this necessarily lead to higher capital standards? Is there any need for legislation in this area if such risk-based standards were to be applied equally to all institutions?

Answer: It should be noted that the so-called "flat-rate" requirement is, in fact, a minimum to be adjusted upward based on the risk characteristics of individual institutions. The so-called risk-based requirement on the other hand sets no minimum and is calculated by applying standard risk weights to categories of bank assets.

A risk-based capital requirement would not necessarily lead to higher capital standards. As a matter of fact, the improvement in the capital positions of the larger banks over the past few years can be traced to the adoption of a simple, easily understood flat-rate capital requirement by the Agencies. Prior to the adoption of these requirements, the Agencies employed various methodologies, including risk-based models, to assess the adequacy of bank capital. My experience with the use of risk-based models is that the process of assigning capital weights to the risks in a given group of bank assets is, in the end, an arbitrary one. Moreover, this process is highly contentious spawning

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self-serving arguments that are almost always aimed at lowering the overall standard. In this environment, the process tends to become the end obscuring the objective of maintaining an adequately capitalized banking system. If a risk-based system is adopted, therefore, it is advisable that a minimum standard be retained as well.

Quite apart from the technical process of establishing a requirement, it is essential that before any further increases in capital requirements are made the Agencies be required to demonstrate that they have given due regard to: (1) the ability of the banks to raise the needed capital; (2) the effect on the banking customer who will pay more for banking services; and, (3) the competitive position of the banking system both domestically and in international markets.

Question:

12. In 1981 and 1982, the banks and thrifts were suffering from disintermediation -- their better customers were flocking to money market funds in droves. Now the concern seems to be that the higher quality loan customers are able to fill their needs elsewhere. The banks point to commercial paper, and the securitization of their loan portfolio. They claim that this trend is being caused in part by their capital ratios and reserve requirements. What is your view? What recommendations do you have for us in this area?

Answer: A growing number of businesses are bypassing the banking system going directly to the commercial paper and other debt markets to meet their credit needs because it

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is cheaper for them to do so. Banks are unable to price their loans competitively with these markets because: (1) they are themselves paying a market rate for a large proportion of their lendable funds; (2) they must maintain sterile reserves against their funds which increases their costs; (3) they must pay the cost of maintaining capital to support their loans. Some relief on the maintenance of sterile reserves either through a reduction in requirements or payment of interest and a lowering of capital requirements would reduce bank costs at the margin and thus enable them to price more competitively. But, such action must be balanced against competing considerations such as the soundness of the banking system, monetary control, and Federal taxation of bank profits. There are no easy answers. The phenomenon of both asset and liability disintermediation is having a profound effect on the U. S. banking system as we have traditionally viewed it. That is why it is so important that discussions of issues such as bank capital adequacy take place in a much broader context than bank failures and the promotion of market discipline.

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Question:

13. With regard to the concern that some states may have expanded banks product authorities beyond what may be prudent, can this issue be dealt with by giving the federal insurance agencies the authority to require a prudent level of capital to support that activity in order to maintain insurance -- rather than giving any federal agency the authority to override a state legislature? in other words, wouldn't the adoption of risk-based capital standards go a long way toward solving this problem?

Answer: The adoption of risk-based capital standards would not go a long way toward solving the problem of States expanding bank product authorities beyond what is prudent. As mentioned earlier, the assignment of risk-based capital requirements is, at best, an imprecise exercise and it would not be practical to establish requirements high enough to protect banks from activities that are patently too risky for a prudent depository dependent on the maintenance of public confidence. Moreover, issues other than safety and soundness such as protecting the public and the institution from conflicts of interests and the need to preserve the impartiality of the credit allocation system are also at stake. These national considerations must be observed by the States, some of whom have expanded bank product lines to address local needs without due regard to these broader objectives. When this happens, they should be overridden in the national interest.

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Question:

15. Even though the FDIC continues to grow, how can or should we determine if the size of an insurance fund is sufficient and will continue to be sufficient?

Answer: I know of no formula for making such a determination. As mentioned earlier, the general perception that the "Government" stands behind the deposit insurance system is probably sufficient to maintain the public's confidence in it as most consumers have no idea of the amount of actual dollars in the insurance funds. From a public policy perspective, however, the funds should be actuarily sound from premiums charged the insured institutions and the insurance funds of sufficient size to readily meet any claims against them even in a period of severe economic downturn. The answer to the question of whether they are sufficient, individually or collectively, to meet the demands of a cataclysm is probably obvious. About all that can be done in a practical sense is to continue to build the funds even if this means increasing premiums. Such increases have to be viewed in the context of the effect on the industry, however.

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Question:

16. In your opinion, what are the advantages and the disadvantages of risk-based capital and risk-based premiums? Should we consider one or the other or both? Why?

Answer: The advantages and disadvantages of risk-based capital requirements were discussed in response to question 11.

The principal advantages of risk-based deposit premiums over the present flat-rate structure in my view are two. First, it is more equitable because the institutions posing the greatest risk to the insurance fund would have to pay the highest premiums. Second, it could act as a disincentive for excessive risk taking by imposing higher costs for doing so.

The disadvantages are: First, it is not likely to have much influence on bank behavior unless premiums are increased substantially above present levels. Second, risk assessment criteria would be extremely difficult to develop and would be the source of constant dispute. Third, it could exacerbate the financial prospects of problem banks by reducing their earnings and making them less able to compete in the market place. Fourth, it could cause bank runs if the public became aware that an institution was paying higher premiums.

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In my view, the disadvantages are substantial, perhaps outweighing the possible benefits. With respect to the fairness issue, the Government sponsored deposit insurance scheme could be viewed as analogous to group insurance where a flat-rate is charged all the participants and the goal is the maintenance of the health of the group as a whole. This provides an added incentive for the participants within the group to discipline each other.

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November 14, 1985

Answers to Questions for Mr. Brooks from Senator Garn

1. Should a federal insurance agency be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed institution with any profit after administrative costs arising from the transaction returned to the original stockholders?

It would be most efficient for a federal regulator to be able to deal with a failing bank prior to the time that the bank actually fails. The problem inherent in such a transaction, however, is one of the valuation of the worth of the failing bank to the stockholders in that bank. While I am confident that this could be done and the results of such valuation be acceptable to a court, I think that such an evaluation would often be challenged by the shareholders who stand most to lose. If such a methodology could be developed, it would ultimately benefit both the FDIC and the FSLIC, as well as the shareholders in the institution prior to its actual failure, and would result in less loss to the insurance funds than if the institution were allowed to continue until it actually became insolvent.

2. If the burden of mismanagement were placed squarely on the managers and stockholders and most failures were handled through a purchase and assumption at an earlier stage - immediately or through a conservatorship - regardless of size - wouldn't this dispose of the fairness question as it relates to large and small institutions? Why couldn't a Continental type solution be applied to failing small banks? If an insurance agency is funded totally by institutions is there a federal subsidy?

What is meant by the "burden of management" in this question? While the question contemplates that both small and large institutions would be treated in the same fashion, resulting in a fair and equitable treatment for all institutions, the results of the proposal that you put forth in your question means that we will have 100% deposit insurance in this country. If that is the intent of Congress, then fine. To date, however, that has not been the intent of Congress. If the concept of 100% deposit insurance is acceptable, one must look at whether or not "market discipline" exercised by depositors would be non-existent. Regarding the applicability of applying a Continental-type solution to failing small banks, that might be able to be done, but again, it provides 100% deposit insurance. Additionally, the Continental solution was fabricated specifically with Continental in mind, and some of the provisions that were found in the Continental solution may not be as useful in a small bank that is failing. As an example, the provision where the failing bank manages the assets classified loans versus the FDIC managing those assets through its liquidators might not be applicable to a small bank. Regarding the question of whether

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a federal insurance agency is deemed to be funded through a federal subsidy if it is funded totally by depository institutions, I do not think that there is a direct dollar cost to the taxpayers. However, because the insured institution is backed by an agency of the United States Government, with a specific draw on the Treasury Department if it needs it, this certainly gives the insured institution a competitive advantage in its ability to raise funds in the private sector through the selling of its certificates of deposit and other debt instruments.

3. What can be done to prevent covenants in subordinated debt agreements from requiring the FDIC to prevent losses to all creditors as we as the holding company?

Such agreements should not be able to legally bind a 3rd party (the FDIC) as to what action that party must take regarding subordinated creditors, should the bank fail. It is possible the matter could be handled through regulations.

4. Is there a place for self-regulation in the banking industry that draws on the talent within the industry? If so, how could concepts of self-regulation be included in the federal supervisory system?

While there might be some place for self-regulation in the banking industry, I think that ultimately the federal or state regulator must have final control over regulation of banks and thrifts, as long as the federal insurance fund has the risk of bailing out failing depository institutions. Working with the federal insurance agencies, however, the banking industry can certainly agree on many items which would facilitate their operation, the public's understanding of their financial condition, and the ability of the regulator to properly supervise their operations.

5. What is your view of Mr. Keefe's suggestions that
   a. The current loan limit is too high?
   b. Many banks fail due to excessive concentration?
   c. A bank be required to list its 30 largest borrowers by type of company?
   d. The largest banks be required to supply regulators with monthly data?

(a) I have no opinion on whether or not current loan limits are too high.

(b) While many banks fail due to excessive concentration, is this concentration in a particular economic segment of our society, concentration in a particular geographical area, or concentration to one or a group of borrowers?

(c) Would this apply to small banks as well? Would it apply to individual customers of banks if they happen to be among the 30 largest borrowers? I presume the purpose of this

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information will be to allow the regulator to ascertain whether excessive concentrations are occurring by the bank in its loans to borrowers. This information might be useful, but I do not have any opinion as to whether or not it would be merit-worthy.

(d) Monthly data supplied by the largest banks to regulators might prove to be useful to the regulators in their monitoring of the activities of the largest banks, but I have not studied the issue sufficiently to know what kind of information and how often that information needs to be submitted to form an opinion as to whether or not this would be a good idea.

6. Should CPA audits be required of all depository institutions and their holding companies? What steps, if any, should be taken that would permit federal bank examiners to place more reliance on auditors' evaluation of management systems and controls? Would this help examiners focus on asset quality, and bank risk levels, etc?

As long there is federal insurance backing the deposits in depository institutions, all institutions should have a uniform standard of auditing and accounting. Whether or not this requires CPA audits remains to be seen, but I would not object at all to having CPA audits of all depository institutions. Until there is a common standard and procedure applicable to audits of depository institutions, federal bank examiners cannot place much reliance on an auditor's evlauation of management systems and controls. However, I do not think that examiners should place much reliance on auditor's evaluation of management systems and controls, in any event. This would not necessarily help the examiner focus on asset quality and bank risk levels, in that the lion's share of an examination by an examiner really goes to examining the credits in the portfolio of the institution.

7. Would you recommend that federal depository agency personnel be exempted from government pay ceilings? If so, how can this be effectuated?

While it may be a passing phenomenon, it is clear that it is very difficult for the federal bank regulatory agencies to acquire and retain the level of competency in individuals to examine depository institutions. The private sector is offering considerably more money to good examiners to work in depository institutions and especially to work on problem loans. As a result, the current examination force is relatively young, relatively inexperienced, and it is questionable whether, after three or five years of experience, they will remain with the federal government or go into the private sector. A possible solution to this problem is to expand the amount of pay that individuals can earn and whether the solution is to expand the pay ceilings or to remove obstacles found in personnel rules and regulations, or a combination of both, remains to be seen. However, something needs to be done in this area. A justification for modification of personnel rules or increasing the amount of pay that examiners

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and liquidators can get would be that these are people who must possess highly technical skills not necessarily readily available in the market place, and therefore, exemptions from existing rules and regulations is valid.

8. What is your view of permitting federal regulators to require institutions to pay special assessments for the increased examinations made necessary by their classification as a problem institution?

I see nothing wrong with requiring problem institutions to pay the regulators additional fees for examination that are required as a result of their classification as a problem institution. If that were done, it would more evenly spread the burden of the cost of the risks associated with having an insurance fund.

9. If regulators are rarely suprised by a bank failure - isn't the answer swifter or more appropriate regulatory action rather than increased market discipline? Wouldn't giving the regulators the ability to close an institution earlier be appropriate? Should a regulator require bank management to file a confidential bank failure plan approved by its board of directors if it falls a certain percentage below its minimum capital level for a specified period of time?

The answer to this question is very close to the answer to question one. Yes, if regulators have a strong basis and a certain degree of knowledge that an institution is likely to fail, it should have authority to deal with that matter in some fashion prior to its failure. However, the problem with such an approach is how do you value the institution for purposes of shareholders of that institution. As I mentioned before, it is likely that shareholders would strongly disagree with the condition of the institution and the value of their holding in that institution. Having a confidential bank failure plan approved by a board given certain financial conditions of the institution might be a useful endeavor. However, I don not know what you mean by a confidential bank failure plan.

10. What percent of total bank earnings are paid in deposit insurance premiums each year? Has this percentage gone up or down over time? Is there much variance bank to bank or by size of institution?

I do not have the information necessary to answer this question.

11. The appears to be strong support for required risk-based capital - as a method of calculation of capital or as a supplement to the flat rate capital ratios. Would this necessarily lead to higher capital standards? Is there any need for

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legislation in this area if such risk-based standards were to be applied equally to all institutions?

I am one who questions the use of risk-based capital. I have always maintained that there are very few activities in which a depository institution can engage, which, if engaged in properly, are not risky. For example, direct investment in real estate or securities activities, in my mind, are not inherently unsafe or unsound. Texas, for example, has allowed direct investments by financial institutions for over ten years, and there has been very little problem resulting from that kind of activity. It is the manner in which the activity is engaged that determines whether or not that activity becomes risky. As a result, I have a difficult time basing an increased capital requirement on "risks" that an institution engages in. If risk-based premiums were imposed, it might not necessarily lead to higher capital ratios, particularly if the institution chooses not to engage in certain activities that are determined to be more risky than others. However, this would lead us to the situation where we find ourselves today-- where institutions are failing not because of extra-ordinarily new risky activities, but because they have been incompetent in making traditional commercial loans. If risk-based premiums were to be applicable to depository institutions, such premiums could be charged without new legislation being enacted. However, it would be important for all depository institution agencies to agree on what activities would be subject to increased capital. Perhaps this could be done through the Federal Financial Institutions Examination Council.

12. In 1981 and 1982, the banks and thrifts were suffering from disintermediation - their better customers were flocking to money market funds in droves. Now the concern seems to be that the higher quality loan customers are able to fill their needs elsewhere. The banks point to commercial paper, and the securitization of their loan portfolio. The claim that this trend is being caused in part by their capital ratios and reserve requirements. What is your view? What recommendations do you have for us in this area?

Whether or not the concern expressed in this question is valid remains to be seen. I should think that those companies that are issuing commercial paper in order to finance their operations, versus the more traditional borrowing from banks, are very few when compared to the total number of commercial borrowers in this country. I have no recommendations to make in this area.

13. With regard to the concern that some states may have expanded banks product authorities beyond what may be prudent, can this issue be dealt with by giving the federal insurance agencies the authority to require a prudent level of capital to support that activity in order to maintain insurance - rather

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than giving any federal agency the authority to override a state legislature? In other words, wouldn't the adoption of risk-based capital standards go a long way toward solving this problem?

While I question your premise that some states may have expanded banks product authorities beyond what may be prudent, I shall attempt to answer the question as it is posed. Assuming that some states have expanded product authorities beyond what may be prudent, the ultimate risk-taker is not the state, but the federal insurance agency, be it FSLIC or FDIC. As such, it has a strong interest in not only what activities are engaged in by the financial institution, but the manner in which such activities are implemented. In that light, given the option of (1) pre-emption of state laws by a federal authority regarding powers of financial institutions, or (2) establishing some risk-based capital standards to provide a cushion for this undue risk, I would prefer the latter. Perhaps a better third solution would be to devise a regulatory scheme as that proposed by the FDIC in their proposed amendment to 12 CFR 332, wherein they attempt to provide safeguards in a financial institution's implementation of certain powers authorized by the states. Coupled with that kind of regulatory scheme would be a very strong oversight and examination effort by the federal regulator to make sure that the activities engaged in are conducted in a safe and sound manner.

14. Mr. Isaac has stated that a significant number of bank failures are caused by fraud other than increased enforcement actions which are being taken by the federal agencies - aren't Mr. Homan (Former Senior Deputy Comptroller for Bank Supervision, Office of the Comptroller of the Currency) and Mr. Ryan (Former Director, Division of Banking Supervision and Regulation, Federal Reserve System) right as to the importance of the ON-SITE exam to ascertain the intergrity of the numbers being generated and the lack of fraud? If so, does the decrease in on-site examinations bring with it an increase in the risk of fraud? If so, how can this be corrected?

The proposal that on-site examinations of financial institutions be reduced in favor or monitoring these financial institutions, particularly those that have proven to be well-managed institutions, is based upon an assumption that there will be some problem banks and thrifts that will be missed, resulting in the failure of some of these institutions. That is, the lack of monitoring on-site by examiners would, in all probability, result in not catching problems before they got too large to prevent insolvency of an institution. This loss, however, has to be balanced with the fact that there are scarce human resources in the examination ranks, especially those individuals who have a lot of experience not only in years, but in terms of identifying and dealing with problem institutions. Furthermore, these resources are proposed to be concentrated in the larger banks and in those banks that are identified as problem banks in order to closely monitor the latter and better

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analyze the former. It is thought that it is a better tactic to allow a few smaller banks to fail because of lack of on-sight examination, versus letting a much larger bank fail because of lack of resources in properly monitoring and examining the institution. To resolve both problems, a larger. better-trained examination force would be required. Also, less than full-scale examinations on well-run, smaller institutions might reduce the amount of failures that could be expected from not visiting such institutions at all.

15. Even though the FDIC continues to grow, how can or should we determine if the size of an insurance fund in sufficient and will continue to be sufficient?

My measurement as to the adequacy of the fund would be to look at the private sector ratios of the size of the insurance funds to the losses incurred by those funds. I do not know what ratios would be proper or what the ultimate size should be, but at some point, if the fund grows past a particular level, perhaps greater rebates can be given to the insured institutions in addition to what they would currently receive after FDIC takes out its costs of operations for a given year.

16. In your opinion, what are the advantages and the disadvantages of risk-based capital and risk-based premiums? Should we consider one or the other or both? Why?

Basically the answer to this question is found in other answers above. The advantages to both risk-based capital and risk-based premiums are that the institution has a greater cushion upon which to rely should the bank find itself in financial difficulty as a result of its activities. Again, however, in my mind, it is hard to classify one particular activity as being more or less risky than another activity. The bottom line is not the activity per se, but the manner in which the banks engages in the activity. As long as it is prudent in its use of new powers, no additional capital should be needed. In my mind, the better approach would be to have more oversight by the regulator for those institutions which engage in activities which some deem to be "risky". Many would suggest that a very risky activity, in fact, is the making of a commercial loan.

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Senator PROXMIRE. Our final panel is Mr. Edward Kane, professor—Everett D. Reese, professor of banking and monetary economics, Ohio State University, Columbus; and Paul Horvitz, the Judge James Elkins professor of banking and finance, University of Houston.

Mr. Kane, I am delighted to know your parents are in the audience and especially delighted because they are from Kenosha, WI. They are among my bosses, so I'm very happy.

STATEMENT OF EDWARD J. KANE, REESE PROFESSOR OF BANKING AND MONETARY ECONOMICS, OHIO STATE UNIVERSITY

Mr. KANE. I have heard about you from my mother for years.

Senator PROXMIRE. Very good. Thank you.

Mr. KANE. She's one of your greatest fans. She is impressed not only by your accomplishments in Congress, but also by your determination to finance your own campaigns. You must be unique in doing that.

Senator PROXMIRE. Thank you.

Mr. KANE. Thank you, Mr. Chairman.

My analysis of the case for the deposit insurance reform is contained in the forthcoming manuscript—"The Gathering Crisis in Federal Deposit Insurance."

Although the book is not scheduled to be released until Friday, I was able to prevail upon the MIT Press——

Senator PROXMIRE. Gentlemen, you have been extremely patient in waiting and I hesitate to do this, but we have been in session now for 4 hours and you have been very patient. I would appreciate it if you could—because I have had a chance to read your testimony. It's been made available to the press. If you could summarize your testimony in just about 5 minutes and then I've got just a couple of questions because the hour is getting late.

Go right ahead.

Mr. KANE. OK. I think I can do that.

The point I want to make is that I did get a copy of the book in advance to present to Senator Garn and it is inscribed as follows: "Perhaps only a blast-hardened astronaut can pilot Federal deposit insurance into the space age."

As this inscription intimates, our deposit insurance system is subject to explosive forces and has fallen sadly behind the times. My statement tries to explain what has happened and what Congress might do about it.

ABSOLUTE FINANCIAL GUARANTEE

I think the most important thing to be seen is that deposit insurance is not truly insurance at all, but is a financial guarantee. Unlike insurance, which protects against a limited set of hazards, deposit insurance guarantees depositors against any contingency that can impair what we call an insured institution's ability to repay depositors claims.

Essentially, this leads to incentives for managers to try to maximize the value of the guarantee. Now, the market value of a guar-

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antee to a firm's stockholders depends on its benefits and on its costs.

The benefits increase with the risk that the insured institution will prove unable to discharge its obligations under the guaranteed contract and on the perceived willingness and ability of a guarantor to lead its own explicit and implicit commitment. For this reason, the guarantee of a bank loan made to a bag lady would, if issued, say, by David Rockefeller, be almost as valuable as the loan itself. On the other hand, the bag lady's guarantee of Mr. Rockefeller's own debts would be worth next to nothing.

The trouble is that a financial guarantee establishes an asymmetric mechanism for sharing unanticipated gains and losses that would otherwise accrue wholly to the issuer of guaranteed debt.

The mechanism is asymmetric because the guarantor absorbs a larger portion of unanticipated losses than the share it is able to capture of any anticipated gains. Because in liquidation only losses in excess of a firm's net worth are ultimately borne by the guarantor, the asymmetry decreases with the capital of the insured institutions. It also decreases with the extent to which managers of an insured firm see that their own careers might be harmed by leading their firm to economic insolvency.

For national banks, legal insolvency focuses on a firm's liquidity, not on its net worth. This may be contrasted with economic insolvency, which denotes a condition where, after subtracting the market value of a deposit insurance guarantee, the market value of a bank's or an S&L's assets—both on and off the balance sheet—fall short of the values of its nonequity liabilities.

Now, there are two types of counterincentives to risk taking. The first is the market value of the firm's capital—which is to say its degree of economic solvency—and its managers' career risk. These represent deposit insurers' first line of defense against voluntary risktaking. Insurers' supervisory activities represent a second line of defense. Only when both defenses fail, does the value of an institution's deposit insurance guarantee surge out of control.

The issue before this committee is why these defenses are failing so dismally today. The short answer is that the benefits of the guarantees have increased as the economic environment became riskier, while deposit insurance costs have failed to adjust appropriately. Effective insurance premiums have responded slowly and imperfectly.

In particular, authorities have permitted hundreds of institutions to operate long after the market value of their net worth has been exhausted. Authorities' reluctance to resolve economic insolvencies as they arise has sharply reduced the de facto risk rating in effective deposit insurance costs.

The operative policy problem is how to reestablish a de facto risk-rating schedule that is steep enough to bring insured institutions voluntary risk taking back under control. Because we are trying to price financial guarantees rather than insurance proper, our goal should be to develop a balance and interdependent package of complementary implicit and explicit premiums, some of which it is advantageous to collect ex post—that is, after the fact—as opposed to collecting all fees ex ante or before the fact. It would be mistake to look for a one-dimensional solution.

This brings me, at last, to the four general questions on the take-home examination paper your committee staff gave Mr. Horvitz and me to work on last week.

The first question was: Can we improve examiners' ability to assess the condition of financial institutions?

Basically, I think we can do this in two ways. One is to see that the examiners are paid well enough to attract and retain topnotch people. The current rapid turnover of examiners puts too many rookies into the game and suggests that many of the potentially more skilled examiners are being quickly bid away to other kinds of employment.

However, examiner effectiveness could also be enhanced by improving the information system within which examiners must work. I mean by this, adopting market value accounting and reorienting of examiner activity to look harder for evidence of fraud and embezzlement.

Financial institution managers currently have too much discretion over the extent to which current problems show up on an institution's income statement and balance sheet. What is needed is a positive obligation to make regular and adequate disclosure of the income and balance sheet consequences of all material events.

The second question asked was: How should laws and regulations differentiate between institutions?

FOCUS ON FIRM'S NET WORTH

To my mind, regulators should focus on the market value of a firm's net capital—the market value of a firm's true net worth—not it's book value. This magnitude should be calculated net of the market value of the firm's aggregate deposit insurance guarantees.

The measure of net worth has to be based on what economists call a firm's expanded balance sheet, which seeks to incorporate all sources of value to the firm. For regulatory purposes, accountants' distinction between bookable and unbookable—or off-balance-sheet—assets and liabilities is mischievous in the extreme. Focusing on net market values would raise the effectiveness of existing capital requirements and administrative penalties in a risk-sensitive way.

In effect, the opportunity cost of having to acknowledge the market value of a firm's net capital grows with its risk exposure. Accounting standards that enable individual managers to cloak insolvency and risk taking without formally violating any laws undermine the effectiveness of existing capital requirements. Until these standards are changed, sophisticated managers will be able to blunt the thrust of efforts to end deposit insurance subsidies by raising or restructing capital requirements.

A number of additional measures would also be helpful. One is to roll back account coverages, say to $10,000. A second, would be to extend the liability of deposit institution stockholders to two or three times the par value of their stock. A third step would be to impose risk-rated explicit premiums.

The third question asks how regulators should resolve economic insolvencies?

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I have paraphrased this question to highlight the distinction between the occurrence of economic insolvency, that is, a condition of negative net capital and an institution's failure. While economic insolvency is a market-determined event, failure is a regulatory decision. Failure is, in fact, a regulator-induced cessation of autonomous operations.

This issue are two subissues: The first concerns policies for insolvency resolution, while the second concerns whether and how insurers and the Fed should undertake direct lending to troubled insured institutions.

Suppose authorities had an information and insolvency response system that was good enough to let them take over and dispose of insured institutions before what we have called their net capital was exhausted. In this case, the deposit insurance funds would have monitoring costs to recover, but no risk exposure from even their riskiest and most dishonest clients.

Empirically, large claims on deposit insurance reserves have come mainly from two sources: Managerial fraud and desperately risky and end-game plays made by insured institutions allowed to remain in operation long after they've become economically insolvent.

Extending stockholder liability and precommitting Federal regulators to impose "financial haircuts" on uninsured creditors in the event that losses are incurred in what turn out to be less timely closures would let market discipline carry the effective burden of enforcing insolvency resolution.

I'll skip over the discussion of direct lending, except to make the point that what's important is to lend to economically solvent institutions and not to insolvent ones. In the past the contagion of troubles from one institution to another has been used as a rather lame excuse for myopic and rather fainthearted preference for ignoring——

Senator PROXMIRE. If you would summarize.

Mr. KANE. OK.

The last question is: Is there a role for private deposit insurance?

Here, again, the role is mainly as a market check on Federal deposit insurance fees and in providing supplementary or overline insurance coverages.

Finally, to summarize, in recent years, maintaining the perfection of the nominal guarantees provided by Federal deposit insurance has imposed large implicit costs on Federal taxpayers. Underpricing Federal deposit insurance has made it easier for Federal agencies to keep the true cost of the fainthearted insolvency resolution policies they have followed from appearing in their budgets.

However, these costs show implicitly in the growing market value of aggregate deposit insurance guarantees and in increasing public doubts about the adequacy of accumulated deposit insurance reserves.

Rising deposit insurance subsidies to risk-bearing have led U.S. financial firms to take risks that are not in societies interest and to spend resources for additional ways to access these subsidies.

[The complete prepared statement follows:]

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Statement for the U.S. Senate Committee
on Banking, Housing and Urban Affairs
July 23, 1985

STATEMENT ON DEPOSIT INSURANCE REFORM

Edward J. Kane
Reese Professor of Banking and Monetary Economics
The Ohio State University

Mr. Chairman, I want to congratulate you and your committee for deciding to take a hard look at the deposit-insurance system and to thank you for inviting me to comment on the nature of the reforms that are needed. My analysis of the case for deposit-insurance reform is contained in a forthcoming manuscript, The Gathering Crisis in Federal Deposit Insurance. Although the book is not scheduled for publication until Friday, I was able to prevail upon my publisher, the MIT Press, to fabricate a hand-bound prepublication copy for me to present to you today. It is inscribed as follows: "Perhaps only a blast-hardened astronaut can pilot federal deposit insurance into the space age."

Incentive Problems in Deposit Insurance

As this inscription intimates, our deposit-insurance system has fallen sadly behind the times. To explain how this has happened and what Congress might do about it, it is important to clarify that deposit insurance is not truly insurance at all. It is in fact a form of financial guarantee. Unlike insurance which protects only against a contractually limited set of hazards, deposit-insurance guarantees protect depositors against any contingency that could impair what we call an "insured" institution's ability to repay depositor claims. A guarantee's value to insured institutions lies in permitting them to borrow on guaranteed instruments at lower interest rates than their leverage positions and the inherent riskiness of their business operations would otherwise permit.

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Other things equal, managers of insured institutions face incentives to maximize the value of the deposit-insurance guarantees their firms enjoy. Because the set of events that expose the guarantor to potential losses cannot be enumerated in advance, the market value of a guarantee cannot be found by standard actuarial methods. Instead, techniques of financial analysis must be employed.

The value of a guarantee to a firm's stockholders depends on its benefits and on its costs. The benefits increase with the risk that the insured institution will prove unable to discharge its obligations under the guaranteed contract and on the perceived willingness and ability of the guarantor to meet its own explicit and implicit commitments. For this reason, the guarantee of a bank loan made to a bag lady would, if issued (say) by David Rockefeller, be almost as valuable as the loan itself. On the other hand, the bag lady's guarantee of Mr. Rockefeller's own debts would be worth next to nothing.

Holding the benefits conferred by a deposit-insurance guarantee constant, its net value is reduced by the costs that the guarantor imposes on the insured institution. The several dimensions of these costs are the subject of today's hearing: pricing, guarantor rights, monitoring, and enforcement.

To protect itself against voluntary risk-taking (i.e., moral hazard), it is seldom optimal for a guarantor to rely merely on ex ante pricing. Financial guarantees establish incentives for insured institutions to look for ways to exploit the guarantor. In practice, no matter how much risk an insured institution may take, FDIC and FSLIC funds are at risk only because monitoring difficulties, and legal and political constraints frequently prevent them from closing a troubled institution before its net worth is exhausted. To control insurers' exposure to client risk-taking, it is prudent to establish meaningful coverage limits, erect a system for monitoring the risk-taking of guaranteed parties, and negotiate a

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system of required and forbidden behaviors backed up by contingent penalties and takeover rights which the guarantor can exercise in response to adverse developments. As long as managers of insured institutions firmly believe that the guarantor can and will impose ex post penalties on them for excessive risk-taking, the monitoring and response systems function as implicitly risk-rated premiums.

To sum up, a financial guarantee establishes an asymmetric mechanism for sharing unanticipated gains and losses that would otherwise accrue wholly to the issuer of guaranteed debt. It is asymmetric because the guarantor absorbs a larger portion of unanticipated losses than the share it is able to capture of unanticipated gains. Because in liquidation only losses in excess of a firm's net worth are ultimately borne by the guarantor, the asymmetry decreases with the capital of the insured institution. It also decreases with the extent to which managers of an insured firm perceive that their careers might be harmed by leading their firm to economic insolvency. Legal insolvency focuses on a firm's liquidity (i.e., its ability to service its obligations as they come due or accrue). Economic insolvency denotes a condition in which, after subtracting the market value of deposit-insurance guarantees, the market value of a firm's assets (both on and off the balance sheet) falls short of its nonequity liabilities.

Counterincentives

The market value of a firm's capital (i.e., its degree of economic solvency) and its managers' career risk represent deposit insurers' first line of defense against voluntary risk-taking. Insurers' supervisory activities represent a second line of defense. Only when both defenses fail does the value of an institution's deposit-insurance guarantee surge out of control.

The issue before this committee is why these defenses are failing so dismally today. The short answer is that the benefits of the guarantee have increased as the economic environment became riskier while deposit-insurance costs did not adjust

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appropriately. Effective premiums have responded slowly and imperfectly. In particular, authorities have permitted hundreds of institutions to operate long after their net worth has been exhausted. Authorities' reluctance to resolve economic insolvencies as they arise has sharply reduced the de facto risk-rating in effective deposit-insurance costs. This reluctance is rooted both in bureaucratic lags in recognizing the implications of innovative forms of risk-taking and in political protections against insurer-instigated sanctions that particular forms of risk-taking (such as undiversified agricultural lending) enjoy.

The operative policy problem is how to re-establish a de facto risk-rating schedule that is steep enough to bring insured institutions' voluntary risk-taking back under control. Because we are trying to price financial guarantees rather than insurance proper, our goal should be to develop a balanced and interdependent package of complementary implicit and explicit premiums, ones that can be levied in ex post as well as ex ante fashion. It would be a mistake to look for a one-dimensional solution.

Discussion of the Four Questions Posed by the Committee

This brings me at last to the four general questions your committee asked witnesses to address.

1. Can We Improve Our Ability to Assess the Condition of Financial Institutions?

An examiner's job is to ferret out evidence of managerial dishonesty or incompetence and of the extent to which deposit-institution managers succeed in exploiting deposit-insurance subsidies to risk-taking. Their effectiveness could be improved by seeing that examiners are paid well enough to attract and retain top-notch people. The current rapid turnover of examiners puts too many rookies in the game and suggests that many of the potentially most-skilled examiners are being quickly bid away to other kinds of employment.

However, examiner effectiveness could also be enhanced by improving the information system with which examiners must work. I mean by this the adoption

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of market-value accounting and the reorientation of examiner activity to uncovering evidence of fraud and embezzlement. Financial-institution managers currently have too much discretion over the extent to which current problems show up on an institution's income statement and balance sheet. What is needed is a positive obligation to make regular and adequate disclosure of the income and balance-sheet consequences of all material events.

I maintain that, because heads of regulatory agencies typically have short horizons, banking agencies have naturally favored reporting systems that tend to delay the development and disclosure of disagreeable information. Systematically deferring action against marginally insolvent institutions lightens an agency head's job and improves the public's perception of his or her performance. In addition, to the extent that managers of insured institutions thought that they could increase the flow of expected subsidies by making it harder for examiners to monitor their behavior, a complementary industry interest developed in limiting voluntary public disclosure.

I believe that, since at least the mid-1970s, the distribution of benefits from nondisclosure has become skewed toward high-flying and loosely managed firms. I also believe that recent experiences are teaching this lesson to regulators and managers of mainstream deposit institutions. The experiences I have in mind are:

1. The way that the failure of a single large institution increased the future insurance costs of other institutions that belonged to state-sponsored insurance systems in Ohio and Maryland;
2. The FSLIC's imposing in 1985 a supplementary premium of 1/32 of one percent per quarter on surviving S&Ls;
3. The growing likelihood that, if the overburdened FSLIC were to become legally insolvent, Congress would probably spread the costs of rescuing S&Ls onto commercial banks by merging the FSLIC into the FDIC.

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Historical-cost accounting (which does not recognize such obvious losses as those on low-interest mortgages and loans to Argentina) encourages regulators to postpone actions that could resolve emerging economic insolvencies at problem thrift institutions and banks before they became major. Had market-value (i.e., mark-to-market) accounting of insured institutions been in place during the last decade, political pressures would have developed long ago to arrest the FSLIC's disastrous slide into economic insolvency. By focusing attention on changes in the market value of the guarantee an insured institution receives, market-value accounting ought to have led regulators to require a troubled institution to begin action to reduce this value or else.

2. How Should Laws and Regulations Differentiate Between Institutions?

To my mind, regulators should focus on a firm's "net capital:" the market value of a firm's true net worth, net of the market value of its deposit-insurance guarantee. The measure of net worth should be based on what economists call a firm's "expanded" balance sheet, which seeks to incorporate all sources of value to the firm. For regulatory purposes, accountants' distinction between bookable and unbookable (or off-balance-sheet) assets and liabilities is mischievous in the extreme.

Focusing on these market values would raise the effectiveness of existing capital requirements and administrative penalities in a risk-sensitive way. In effect, the opportunity cost of having to acknowledge the market value of a firm's net capital grows with its risk exposure.

Accounting standards that enable individual managers to cloak insolvency and risk-taking without formally violating any laws undermine the effectiveness of existing capital requirments. Until these standards are changed, sophisticated managers will be able to blunt the thrust of efforts to end deposit-insurance subsidies by raising or restructuring capital requirements.

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A number of other measures would also be helpful, including:

1. Rolling back account coverages to (say) $10,000. This would leave perfect federal guarantees available to the bulk of the population, while letting households with large balances save taxpayers' funds by finding perfect guarantees in Treasury securities when they want them.
2. Extending the liability of deposit-institution stockholders to two or three times the par value of their stock. (Extended liability is a time-tested way to reduce risk-taking incentives and existed for stockholders in national banks until the 1930s.)
3. Imposing risk-rated explicit premiums. (This issue requires too extensive a treatment to be disposed of here. Clearly, premiums should be sensitive to a firm's leverage, asset quality, duration gap, and other business risks. I would also point out that if the market value of deposit-insurance guarantees is estimated, it can be used as the basis for an ex post settling up for the market value of guarantee services an institution actually receives in any period. The appropriate fee -- which could on occasion actually be a rebate -- would be the sum of two components: (a) the change in the market value of the guarantee over the accounting period, and (b) the interest cost over the same period of financing the average value of the guarantee. What is nice about such an approach is that it can be used to price away the subsidy that large banks currently derive from the perception that they are too large for authorities to liquidate.)

3. How Should Regulators Resolve Economic Insolvencies?

I have paraphrased this question to highlight the distinction between the occurrence of economic insolvency (i.e., of negative net capital) and an institution's failure. While economic insolvency is a market-determined event, failure is a regulatory decision. Failure is a "regulator-induced cessation of autonomous operations."

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a. Insolvency Resolution

If authorities had an information and insolvency-response system that was good enough to let them take over and dispose of insured institutions before what we have called their "net capital" was exhausted, deposit insurance funds would have monitoring costs to recover, but no risk exposure from even their riskiest and most dishonest clients. Investigating the political viability of such a system and estimating the costs of installing and operating it should be regarded as research issues of the highest priority.

Empirically, large claims on deposit-insurance reserves have come mainly from two sources: managerial fraud and desperately risky endgame plays made by insured institutions allowed to remain in operation long after they became economically insolvent. This observation confirms the theoretical hypothesis that information risk, bureaucratic lags, and legal and political restraints on closing economically insolvent institutions underlie the imperfect controllability that, together with limited liability, creates risk-management and pricing problems for deposit insurers.

Extending stockholder liability and precommiting federal regulators to impose financial haircuts on uninsured creditors in the event that losses are incurred in less timely closures would let market discipline temper the aggressiveness of the insurers' insolvency-resolution policy.

b. Direct Lending to Troubled Institutions By Insurers and the Fed

Direct lending to a troubled institution seeks to relieve what is merely a shortage of liquidity or to prevent a substantial financial shock experienced by an individual institution from spreading and destabilizing the condition of other institutions in the financial system. In the face of a run on an individual institution that its managers cannot handle by borrowing from private sources, direct assistance should be provided at market interest rates whenever and as long as the

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institution appears to be economically solvent. (Of course, estimating the value of a firm's net capital would be easier if market-value accounting is adopted.) Such a policy seeks to prevent economically solvent institutions from being forced into insolvency by having to sell off substantial amounts of illiquid assets at bargain-basement prices. To protect the value of the government's stake, the resulting loans should be collateralized and the firm's net capital position monitored continually.

Lending to an economically insolvent institution is harder to justify. To prevent the spread of a financial shock, it is possible that the costs of insolvency resolution can occasionally be minimized by lending to an economically insolvent institution. However, an economically more reasonable policy would be to provide assistance to whatever economically solvent institutions are subject to secondary shocks from the original insolvency.

To keep Fed and insurance-agency lending commitments from becoming a regular source of unintended subsidies, these parties must establish and adhere to strict guidelines concerning what collateral, loan-to-value ratios, and net capital positions are acceptable. While some of these guidelines could be relaxed when liquidity pressures are clearly systemwide, this flexibility should not be permitted to become a loophole through which regulators' traditionally myopic and faint-hearted preference for ignoring "minor" economic insolvencies could reassert itself. I would suggest prohibiting loans to economically insolvent institutions except when 5 or 10 percent of deposits either in the nation or in the institution's Federal Reserve District have already been involved in institutional failures during the previous year.

4. Is There A Role for Private Deposit Insurance?

Private deposit insurance can provide a useful market check on federal deposit-insurance fees. Such market checks are important precisely because the

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perfection inherent in federal guarantees doesn't come cheap and political goals and constraints frequently make it optimal for an agency to underprice its services.

To lessen the inordinately large costs of providing guarantees for large accountholders, it would be useful to establish more flexible deposit-insurance contracts. If basic FDIC and FSLIC coverages were rolled back to $10,000 or so, private firms could sell optional supplementary coverages either to institutions or to individual accountholders. As customers chose among the alternative deductible and coinsurance provisions offered by different companies, they would generate information regulators could use to improve the reliability of the risk-rating process.

It is inherently difficult for teams of individual regulators to set appropriate ex ante premiums, even for such conceptually straightforward risks as those due to fraud, variations in asset quality, and asset-liability mismatching. It is better to view risk-rating as a problem for financial markets instead of bureaucrats to solve. In fact, bond markets solve such problems every day.

Obviously, relying on private guarantors would increase the chance of observing a guarantor insolvency. This illustrates the interdependence of our reform package by bringing us back to the need for improved methods of insolvency resolution. Unless uninsured creditors and private guarantors undergo assured financial haircuts, anticipatedly myopic political responses to the threatened insolvency of an important guarantor could undo most of the supposed benefits of private competition.

The Urgency of Deposit-Insurance Reform

In recent years maintaining the perfection of the nominal guarantees provided by federal deposit insurance has imposed large implicit costs on federal taxpayers. Underpricing federal deposit insurance has made it easier for federal agencies to keep the true costs of the faint-hearted insolvency resolution policies

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the U.S. has followed from appearing in their budgets. However, these costs show up implicitly in the growing market value of aggregate deposit-insurance guarantees and in increasing public doubts about the adequacy of accumulated deposit-insurance reserves.

Rising deposit-insurance subsidies to risk-bearing have led U.S. financial firms to take risks that are not in society's interest and to lobby for additional ways to access these subsidies. In pursuing these subsidies, managers no more intend for their firms to fail than the owner of a valuable car that is perfectly insured against losses from theft would intend for his automobile to be stolen. The point is that when insured parties who install burglar alarms and sturdy locks on their cars are not offered compensating reductions in their insurance premiums, their natural interest in installing alarm systems and heavy-duty locks is clearly weakened.

As I emphasized in testimony before this committee last June, incentive problems inherent in the design of the deposit-insurance system lie at the heart of most of the financial industry's most urgent structural problems. No lasting solution to these problems can be fashioned until these incentive problems are corrected.

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Senator PROXMIRE. Thank you very much.
Mr. Horvitz.

STATEMENT OF PAUL M. HORVITZ, JUDGE JAMES A. ELKINS PROFESSOR OF BANKING AND FINANCE, UNIVERSITY OF HOUSTON, HOUSTON, TX

Mr. HORVITZ. Well, I think I can make this brief by saying pretty much I agree with what Professor Kane has said.

There is just one point I would like to make that I think that I find often overlooked in discussions of deposit insurance, and it has some important implications for some of the proposals for reform of the system that have been made.

It is important to distinguish risk of bank failure from losses of the deposit insurance system. We could have a financial system in which bank failures would be virtually nonexistent, but that would mean much more intensive regulation of banks and restrictions on them, such that they would not be able to provide the services that we expect of them.

The route this country has taken, rather, has been one of allowing banks to fail but protecting the public from the ill effects of failure through deposit insurance. That system has worked well 50 years in protecting depositors from loss and the economy from financial instability.

But that makes it necessary to protect the deposit insurance from loss and to minimize its losses due to failure. But that does not require preventing bank failures.

THREE KEYS TO PROTECTING PRESENT SYSTEM

There are three keys to protecting the deposit insurance system: A capital requirement on banks, a good monitoring system, and prompt action to close the bank when its net worth is depleted.

Most bank failures do not occur as a result of a single sudden event but rather result from losses incurred over time.

If the FDIC can monitor the net worth of insured institutions and take action to close a bank when its net worth reaches zero, then the bank will fail but the insurer will suffer no loss. The FDIC has only suffered substantial losses when banks were allowed to operate long after they were truly insolvent.

This has generally occurred when, as a result of fraud, the FDIC is unaware of the insolvency. Thus, the FDIC suffered large losses from the U.S. National Bank of San Diego, Penn Square, the Butcher banks in Tennessee, but not in the much larger First Pennsylvania or Franklin National failures.

Fraud may not be the leading cause of bank failure, but it is the leading source of FDIC losses. It is important to assure that banks are operating with their own funds at risk, and hence the increased capital requirements imposed recently by the bank agencies are a step in the right direction.

Ultimately, savings and loans are going to have to meet similar requirements.

Once institutions are insolvent and are playing with the insurance agency's money rather than their own, then they have every

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incentive to take great risks. Every effort must be made to improve the monitoring system.

One helpful step would be to require more information on the market values of bank assets and liability. It is not necessary that financial statements be prepared on a current value basis. As Mr. Isaac pointed out, that would be very difficult. But the information on the market value of assets and liabilities should be available to the regulator and to the market.

This suggests that the focus of bank examinations should be a little different than it has been in the past. One important task of bank examination is simply to make sure the reports filed by the banks are accurate. The monitoring system relies heavily on such reports, and an examination is the best means of assuring that they can be relied on.

Second, bank examination must be more attuned to detecting fraud, because that is where the risk of a large loss lies.

The best protection for the deposit insurance fund is the ability to close the bank when its net worth is depleted. I believe the FDIC should be given authority to make that determination and to take over the bank, either close it, or merge it, or operate it under a conservatorship or trusteeship.

It is difficult, of course, to determine the exact moment at which net worth is depleted. A useful cushion is provided if the bank is required to have some portion of its capital in the form of subordinated debt.

I agree with Chairman Isaac's proposal for increasing bank capital through use of subordinated debt, but I would make use of that instrument mandatory rather than optional.

In summary, there is no single solution or magic bullet for the problems of the deposit insurance system or the soundness of the banking system. The steps discussed in my statement can contribute to a solution without requiring reregulation, and I just list the recommendations that are discussed in the statement: Increased capital in the form of subordinated debt; current value or market value reporting; and enhanced powers for the FDIC in handling failing banks, including the power to close banks.

Risk-related premiums, while not a complete solution, may offset the tendency of deposit insurance to stimulate risk taking.

Private deposit insurance of deposits over $100,000 can be a useful supplement to Federal insurance. Such private insurance should be encouraged, and the Federal agencies should be required to cooperate with private insurers.

Greater use should be made of computerized early warning systems and other devices, but onsite examinations are necessary and should put greater emphasis on detection of fraud.

And, finally, to resolve any doubts as to the intention and ability of the deposit insurance system to meet its responsibilities, deposit insurance funds should be replaced with an explicit Government guarantee.

[The complete prepared statement follows:]

STATEMENT OF PAUL M. HORVITZ, JUDGE JAMES A. ELKINS PROFESSOR OF BANKING AND FINANCE, UNIVERSITY OF HOUSTON

Federal deposit insurance has been one of the few great success stories of government intervention in the marketplace. The U.S. banking system was plagued by instability from its earliest days. The bank failures that were a common event in the U.S., even in prosperous periods such as the 1920's, represented personal tragedies to those whose savings were lost as a result of failures. The menu of financial assets in which the savings of people of moderate means could be held was a very short one, and bank deposits represented the primary form in which savings balances (not just transactions balances) were held.

The Federal Deposit Insurance Corporation (FDIC) was created to deal with both problems--monetary instability and protection of the small depositor. Before establishment of the FDIC, it was possible for a sound financial institution to suffer a sudden withdrawal of deposits in resonse to rumors or doubts about its financial condition. This could result from the failure of a nearby institution and the fact that participating in a run is not irrational: it costs very little to withdraw funds from a bank on the basis of a rumor that turns out to be false, while the cost of not removing funds quickly from a bank that is truly about to fail is very large. Even the customer who knows that the bank is sound has an incentive to get his funds out before the actions of other depositors bring down the bank.

It is possible that we have tended to exaggerate the social costs of bank runs. A recent study by Professor George Kaufman concludes that, with the possible exception of the Great Depression of the 1930's, bank runs have not caused the failure of sound banks. Contrary to some published reports, runs did not cause the failure of Continental Illinois, Home State Savings of Cincinnati, or Old Court Savings of Baltimore. More important, with a well-functioning central bank, runs cannot cause a collapse of the banking system. Also, fear of runs may lead bank managements to operate in a more conservative manner than they otherwise would.

Nevertheless, runs are clearly disruptive. Moving funds around from bank to bank may not cause the system to collapse, but it does represent a waste of real resources. Federal deposit insurance has solved that problem. Runs on federally-insured institutions do not take place, even when institutions are known to have substantial financial problems. Savings and loans have been able to continue operating despite sizable operating losses and negative net worth on a market value of assets basis (and a number of institutions continue to operate with negative net worth on a book value basis). Furthermore, this stability has carried over to uninsured depositors. Because most failures have been handled through mergers or other arrangements that have protected all creditors, even uninsured depositors have been willing to leave their funds in banks known to have problems.

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The FDIC and the Federal Savings and Loan Insurance Corporation (FSLIC) have protected small depositors and virtually eliminated the problem of runs at a remarkably low explicit cost to insured institutions. Losses suffered by the FDIC have been low, partly because of the favorable economic environment for most of its history and, more importantly, because the banking system has been subject to an extensive and intensive system of regulation and supervision. In the absence of regulation, deposit insurance would tend to increase the level of risk in the banking system. That is, deposit insurance reduces the effectiveness of market forces that would otherwise restrain risk-taking. Insured depositors no longer care about the soundness of their banks, so banks face no market penalty for investing in risky assets or activities. Without deposit insurance, the market would impose a discipline by increasing the cost of funds to institutions that take increased risks.

Under present arrangements, deposit insurance actually provides an incentive for increased risk-taking. Since the insured bank does not pay increased deposit insurance premiums, and does not face increased interest costs if it adopts a risky posture, the owners of the bank gain the increased returns that may be associated with increased risk. On the other hand, if the risks turn out badly, and the institution fails, the costs are borne by the insurance agency.

While academic economists have long discussed this problem, it was more theoretical than real for the first thirty years or so of the life of the FDIC and FSLIC. Bankers were generally a conservative group who operated in a cautious manner, despite this economic incentive toward risk-taking. They had first-hand knowledge of the problems of the banking industry during the Great Depression, and that experience tempered temptations toward risky activities. Also, as problems did develop over time, the insurance system was protected with increased regulatory powers.

Increased Risk to the Deposit Insurance System

While the system appears to have worked well for fifty years, recent developments in the economy and in the financial system raise legitimate questions about whether some basic changes in the structure of deposit insurance are needed. The most important of these developments is the move toward deregulation. The link between deregulation and the soundness of the insurance system was recognized by Congress in passage of the Garn-St Germain Depository Institutions Act of 1982. That legislation required the federal deposit insurance agencies to report to Congress on several aspects of deposit insurance. The agency reports and other recent studies of deposit insurance suggest that financial institutions and their insurers face greater risks in the future than was the case in the past. It may be helpful to set forth some of these sources of increased risk:

(1) Interest rate risk is greater than it used to be (or was perceived to be) in the 1950's and 1960's. Even though interest

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rates have not been as volatile in 1984 and 1985 as in the preceding years, bankers and bank customers are more aware of how volatile interest rates can be. Bank depositors seem to have a distinct preference for short-term instruments, while borrowers seem to prefer long-term, fixed-rate loans. The bank or thrift institution that accomodates its customers' preferences will tend to be borrowing short and lending long. There are, of course, many ways for a bank to minimize its interest rate risk, but such approaches have costs or reduce profit margins. In this environment, some institutions will take greater interest rate risk, and some will suffer losses.

(2) Banks have assumed greater credit risks. The economic recovery of the last couple of years has not resulted in a reduction of bank loan losses (or volumes of nonperforming loans) to levels of earlier years. There are very substantial risks in the international loan portfolios of many large banks, and in the farm loan portfolios of many small banks. As thrift institutions use their broadened powers to expand into commercial lending or real estate development, their credit losses (virtually negligible in residential mortgage lending) have increased. The major economic achievement of the last five years has been the reduction in the rate of inflation. In the past, however, inflation has bailed lenders out of some serious mistakes, particularly in real estate lending. Declines in the prices of farm products, oil, and real estate benefit consumers of these products, but increase loan losses.

(3) The elimination of interest rate ceilings on deposits benfits the economy as a whole, but it increases bank costs and bank risks. Economists tended to play down this relationship, but interest rate ceilings represented a substantial protection to the insurance system. When ceilings were effective, risk-prone institutions were limited in their ability to attract funds. Now the institution inclined to take greater than normal risks can obtain virtually unlimited funds by simply paying a modest premium over going market rates. If sufficient funds are not available locally, the national market can be tapped through use of brokers. The insured deposit is a uniformly riskless instrument that responsible brokers have no hesitation about selling to their clients. This is the problem that has led the FDIC and the Federal Home Loan Bank Board (FHLBB) to propose restrictions on brokered deposits, and FHLBB to restrict rapidly-growing savings and loans. I do not argue that institutions commit to high interest payments on deposits, and then take unusual risks to earn enough to to cover that cost, but rather that managements seeking to invest in risky assets can always obtain the funds they need to finance that activity.

(4) Most thrift institutions (and many commercial banks) are now operating with lower capital ratios than in the past. For many thrifts, net worth on a market value basis is zero or less. This provides an extraordinary incentive to increased risk-taking. For an institution with no equity capital, any gains that result from excessive risk benefit the institution and its

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owners, while losses that result in failure are borne entirely by the insurance system. Some of these institutions are in such condition that with normal operations they are unlikely ever to return to solvency. For these institutions, a high-risk gamble may be the only hope for survival.

The Need for Reform

These considerations suggest that, despite its apparent success for fifty years, some change in our system of regulation, supervising and insuring depository institutions is necessary if the system is to avoid being sorely tested in the next few years. I see no danger of a collapse of the banking system. My concern rather is with the conflict between the present structure of the deposit insurance system and the desirability of continued deregulation of the financial services business. Eliminating restrictions on the activities of financial institutions and on the pricing of financial services helps consumers and promotes efficiency in the economy. If concern about the safety and soundness of the banking system halts the trend toward deregulation (which has not yet proceeded very far), or leads to "reregulation," these very real benefits to the economy would be lost. It is for this reason that I would like to see some change in the deposit insurance system.

Unfortunately, there is no simple solution to the problems I have sketched. I have no "magic bullet" to propose. In fact, most of the remainder of this paper is devoted to showing why none of the solutions that have been proposed is adequate. What is needed, it turns out, is a coordinated set of changes in deposit insurance that as a whole are adequate to deal with the problem. All of these have long been discussed in the literature and in the reports that FDIC and FSLIC prepared in response to the Garn-St Germain legislation.

The Meaning of Deposit Insurance Risk

The preceding discussion has described several types of "risk" in the context of deposit insurance. Before discussing specific proposals for change in the deposit insurance system, it is necessary to be more precise about the meaning of "risk." In particular, it is important to make a distinction between risk of bank failure and risk of loss to the insurance system.

Deposit insurance is not like life insurance, where risk of death and risk of loss are identical, i.e., when the insured dies, the insurer must pay the contractual amount of the insurance policy. A better analogy is with fire insurance, where risk to the insurer is not the same as risk of fire. Other variables, such as how quickly the fire is detected, whether there are sprinklers, and how quickly the fire department responds, all affect the extent of the damage. The deductible specified in the policy also affects the amount of loss. Small, quickly-extinguished fires that do less damage than the amount of the deductible may be disturbing and costly to the insured, but represent

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no loss to the insurance company.

Furthermore, a life insurance company can not cancel the policy when the insured is on his deathbed, but the deposit insurance agencies have control over the extent of their losses when the insured event (a bank failure) is imminent. Most bank failures do not occur instantaneously, as a result of a single sudden event, but rather result from losses over time. If the FDIC is able to monitor a bank's condition, and closes it when its capital gets to zero, the FDIC suffers no loss. This suggests that the losses of the deposit insurance system are not necessarily closely related to the riskiness of insured institutions, but are more a function of the timing of the closing of a failed bank or savings institution.

This means that if insured institutions are operating with positive net worth, and the insurance agency is able to monitor their condition, then the risk of loss to the insurance agency is low, regardless of the riskiness of individual institutions.

The FDIC and FSLIC have suffered large losses only when these conditions have not been met--that is, where institutions have been allowed to operate without capital, or where fraud has prevented the detection of insolvency. The FDIC suffered large losses in the failures of U.S. National Bank of San Diego, Penn Square, and the Butcher banks in Tennessee. All of these cases involved fraud, and the banks had substantially negative net worth by the time the FDIC took over. The failures of the larger Franklin National Bank and First Pennsylvania were monitored accurately (no fraud was involved) and resolved with no loss to the FDIC. The FSLIC has had large losses when (either because of public policy considerations or because of a lack of legal power to do otherwise) savings and loans were allowed to operate long after they became economically insolvent.

This distinction between bank failure and insurance agency loss has implications for several of the proposals for change in the system. It weakens the case for risk-related deposit insurance premiums, since insurance agency loss is not necessarily a function of the riskiness of insured institutions. It affects the feasibility of private deposit insurance, in that a private insurer may not have the monitoring capability and the right to close a failing institution that are necessary to control loss. It also emphasizes the importance of bank capital to deposit insurance. The remainder of this paper discusses some of these specific proposals in more detail.

Risk-Related Insurance Premiums

The economic literature has generally held that risk-related insurance premiums represent the best way to handle the loss of market discipline that accompanies deposit insurance, and most of the discussion has focused on the question of feasibility. Ideally, premiums would be structured on an actuarially sound basis so that a bank could take whatever risks it wanted, but

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would pay the insurance premium appropriate for that risk. Even apart from the point made earlier that riskiness of the bank is not the same as risk of loss to the insurer, there is general agreement that a completely accurate measurement of risk is not possible.

The key problem, of course, is the difficulty of measuring risks ex ante, that is, before they result in losses. It is unlikely that a risk-related premium system designed ten years ago would have recognized loans to Mexico, or loans secured by proven oil reserves, as particularly risky.

Nevertheless, a system of risk-related premiums could make a positive contribution to the soundness of the system even if it must be somewhat arbitrary. It is possible to measure exposure to interest rate risk, and a system for doing so was set forth in the FHLBB Report to Congress on deposit insurance (though that system has formidable information requirements). As the Report notes, "a perfect measurement system is not necessary for risk sensitive premiums to be useful." All we can reasonably seek is a means of eliminating the incentive toward increased risk-taking that is inherent in the present system of flat-rate deposit insurance premiums.

Market Discipline

Analysis of deposit insurance has always recognized the desirability of including some form of market discipline in the system to reduce the need for governmental regulation and supervision. The U.S. system has always had less than 100% coverage, so that uninsured depositors would have an incentive to choose their bank on the basis of its financial strength and conservatism.

The effectiveness of market discipline emanating from depositors is limited by several factors: First, the high level of coverage (such that thrift institutions have virtually no uninsured deposits); Second, the effectiveness of the deposit brokerage function, so that risky banks can obtain all the insured deposits they want (albeit with some modest increase in interest costs); and Third, the generally desirable practice of the FDIC and FSLIC of resolving most failures through purchase and assumption transactions (P&A's) that protect all depositors. As long as depositors are insured or believe that they will be protected in case of failure, they have no reason to select banks on the basis of their soundness.

The FDIC has experimented with a system of "modified payoffs," that retains the benefits of the P&A, yet imposes some loss on large depositors. The danger of this approach is that if it is applied only to small banks (as the FDIC has done so far), it can lead to a depositor preference for large banks. The end result may be an undesirable concentration of banking resources. It may be possible to expand this approach to large banks, through a device Professor Kaufman has called "modified trustee-

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ship," but the downside of such increased market discipline may be increased instability in banking markets--large depositors would have greater incentives to run from banks at the first rumor of problems.

While I do not see this as a total solution to the problems sketched earlier, modified payoff and modified trusteeship, consistently applied, can contribute to a healthy market discipline. It would increase, however, the pressure on the FDIC to act promptly and correctly when a bank gets into difficulty.

A more useful source of market discipline, in my view, can come from requiring banks to use subordinated debt as part of their capital structure. Holders of subordinated notes are at risk in case of failure, even when the failure is handled through the P&A route that protects all depositors. Appropriate covenants can be devised so that note holders will not have the power to veto FDIC actions that would impose losses on them (existing covenants have forced the FDIC to protect subordinated note holders in some cases).

Because of the nonparticipating nature of capital notes, investors have nothing to gain from increased risk-taking by a bank. In choosing among alternative issues of subordinated debt, they will clearly prefer the safest. They will buy riskier issues only at a substantially higher interest rate.

Further, subordinated debt provides a valuable cushion the the FDIC in its determination of insolvency. Even with the best of monitoring systems, it is impossible to determine precisely when bank net worth hits zero, and when the bank should be closed. If the bank had subordinated debt equal to say, 3% of assets, a decision to close the bank could be delayed until assets were somewhat below liabilities without exposing the FDIC to loss. This cushion, of course, is identical with the cushion provided by equity, but the market discipline of subordinated debt is greater since such notes do not share with equity holders in any gains from increased risk-taking.

Private Insurance

There are some advocates of the replacement of federal deposit insurance by private insurance. This can be based on serious economic analysis (as in the proposals of Bert Ely) or on ideological preferences (as in several papers by Catherine England). Even before the problems in Ohio and Maryland, there were sound reasons to be skeptical of the feasibility of private insurance. Now, regardless of the economic merits, it is fairly clear that a private system is unlikely to be able to maintain public credibility in the face of a serious problem. Moreover, while a private system may promise some advantages as compared with the existing federal system, there is nothing substantive that I see to be gained by a private system over a somewhat reformed federal system.

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Despite my negative views on the value of private insurance as a substitute for federal deposit insurance, I believe it can play a useful role in supplementary insurance, or coverage above the $100,000 federal limit. The private system will almost necessarily involve risk-related premiums, which will represent a test or check on whatever system the federal insurers use, and will represent an additional form of market discipline. Because it can build on the existing federal monitoring and regulatory system, it should be able to hold losses to low enough levels to be economically viable with low premiums. And even if a private system does not have perfect credibility, it may be able to lower the market's risk assessment of smaller banks so that they will be able to compete with the money market and large regional banks. The net effect can be a desirable reduction in pressure toward concentration of resources, without the elimination of market discipline that would result from 100% federal deposit insurance.

Conclusion

In the present economic environment there is legitimate reason to be concerned about bank safety and soundness and the soundness of the federal deposit insurance system. The system has some structural weaknesses that should be corrected. In my view, only modest changes are necessary, and most of those are within the existing powers of the the agencies, and hence do not require legislation.

Because of the importance I attach to accurate monitoring of the financial position of insured institutions, they should be required to report more financial information on a current market value basis. The supervisory agencies should put more emphasis in their examination process on the detection of fraud.

The agencies have moved in the right direction by requiring increased capital for banks. The agencies seem to have recognized that there is no basis for imposing higher requirements on small banks than on large. In the long run, though it may not be feasible today, savings and loans must meet capital standards equal to those of commercial banks. I attach particular importance to a capital requirement that includes use of subordinated debt.

Private insurers, including state-sponsored agencies and trade associations, should be encouraged to offer excess insurance coverage, and the federal agencies should cooperate with them by providing information.

All of these actions can be taken without any new legislation. Legislative action may be necessary to allow use of risk-related premiums, and to allow use of the "trusteeship" arrangement for handling failing large banks. I would like to see the FDIC given the power to close a failing bank.

Even with these changes, there will still be a need for bank

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regulation to assure bank safety and soundness. Such regulation should be limited to what is necessary for that purpose. Protection of the insurance system should not be an excuse to expand economic regulation of financial institutions, such as controls on interest rates offered and charged.

While these changes should assure the continued stability of the FDIC, additional consideration must be given to the current state of the FSLIC fund. Recent estimates by FSLIC staff suggest that it does not have the resources to meet its current responsibilities. So far, there has been no loss of public confidence in FSLIC. There is no reason that I can see for allowing any doubt that FSLIC will meet its insurance obligations. The sense of Congress resolution is inadequate, in my judgement. My preference for dealing with this problem would be to eliminate the insurance funds, and substitute an explicit Treasury guarantee. Deposits should be insured by the federal government, and not by an agency of the federal government with limited resources. We all believe (at least I hope we do) that the U.S. will stand behind the insurance system. If so, we should make that explicit now, and avoid the uncertainties that hit Ohio and Maryland.

Senator PROXMIRE. Thank you very much.

I think these are two excellent and impressive statements, and I very much appreciate it, and I also appreciate the fact that you were able to condense your statements so ably.

CONTINENTAL RESCUE PACKAGE

Mr. Kane, in your view, was the Continental rescue package justified, and, if not, what would you have done if you had been the regulator, to contain the ripple effect of letting Continental go down the tube?

Mr. KANE. Let's start with the ripple effect because that was the only justification I heard offered. The allegation was that a Continental liquidation was somehow going to spread over to other banks that had positions in the institution.

I believe that there was some overstatement in the numbers that regulators originally put out concerning the exposure of other deposit institutions' capital in a Continental liquidation. The issue should not have been posed in terms of the ratio of creditors' total uninsured claims against Continental to their capital. What counts is only the size of the potential haircut to which creditors' claims were exposed. If liquidating Continental could have returned 95 cents on the dollar to its creditors, only 5 percent of uninsured claims should have been compared against the capital of creditor institutions.

In many cases, creditor institutions could have absorbed their losses without failing. But if authorities wanted to reduce these losses or save institutions with severely exposed positions, they could have stepped in with emergency loans or grants to Continental's creditors. Bailing out Continental's stockholders and nondeposit creditors was not the only way to make good the losses to its uninsured depositors.

Senator PROXMIRE. Let me just interrupt to point out, No. 1, you had 2,000 small banks that had about $6 billion in deposit with the

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Continental and you also had about $15 or $16 billion of foreign government deposits, and if they had taken a bath we would have been in real trouble in the enormous amount of borrowing we would have to make with our colossal Federal deficit abroad.

So it seems to me we really didn't have much choice other than to save Continental from going under.

Mr. KANE. My objection is less to helping small banks and foreign governments than to adopting a policy that left millions of dollars on the table for Continental stockholders and their creditors. That is my principal objection. Although I would have liked to have seen a 1-to-5-cent haircut for uninsured creditors, authorities can provide welfare for creditors and depositors as they wish. However, if the magnitude of these subsidies were less hidden, I believe that taxpayers would have required the aggregate subsidy to be smaller.

Senator PROXMIRE. Isn't that pretty much what we did? People say, "You bailed out Continental." Management was knocked out and replaced. You now have a different top management in the Continental, so that as far as the discipline of the marketplace working, it worked.

Mr. KANE. I have to disagree with you, Senator. What happens to management is not essential to my argument. The stock-market value of the firm on the day Continental's insolvency was resolved was $150 million. Moreover, the debt of the holding company was guaranteed by the FDIC as a part of this arrangement. This is not what would have happened in a liquidation. Stockholders and creditors of the holding company would have suffered additional losses.

Senator PROXMIRE. People with stock in the Continental Bank, that stock was virtually valueless.

Mr. KANE. Well, the aggregate value of stock claims was $150 million. I don't call that virtually valueless.

Senator PROXMIRE. But $150 million compared to—what was it the year before?

Mr. KANE. Sure, before the crisis the stock was worth a great deal more. I would imagine it was on the order of 10 times, but that still is not zero. That $150 million could have been paid to the taxpayers.

Senator PROXMIRE. That $150 million all goes to the FDIC to cover the loss.

Mr. KANE. No, it was retained by Continental stockholders. The FDIC warrants were recognized as an existing residual value against the claims that the holding company and any minority stockholders still had in the bank.

Senator PROXMIRE. Mr. Horvitz.

Mr. HORVITZ. I disagree with Professor Kane. I believe the handling of Continental was a neat solution. It did virtually wipe out the stockholders. The only way the stockholders saved value was by exercising their right to put in additional money for the new Continental.

So the only way they came up with any value was to put in additional money, so they were virtually wiped out. It would have been nicer if the creditors of the holding company could have suffered a loss. But the holding company had other assets as well, and even

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under bankruptcy the creditors of the holding company would have come up with some value.

So I think the solution was a good one.

Mr. KANE. The other point that needs to be made concerns the decision to give guarantees to the creditors of the holding company. This was an unprecedented and perhaps illegal action. It establishes a dangerous new precedent. I conceive it as having extended the conjectural liabilities of the FDIC and FSLIC in an irresponsible way.

Senator PROXMIRE. Mr. Horvitz, it seems to me, makes a pretty strong point when he argues that as far as the stockholders are concerned they have to put in new money in order to have any real equity left.

Mr. KANE. Well, existing stockholders were equally free to sell their stock to someone who was willing to put his or her funds in. The market value of Continental stock certificates was determined in the aggregate to be $150 million. That is the crucial point. In liquidation, that $150 million would have been captured for the Federal taxpayer.

But I agree that the issue concerns trading off short-run benefits for long-run costs. That is why I used the word "myopic."

Senator PROXMIRE. Let me ask you this, Mr. Kane—Professor Kane.

Chairman Isaac said the market value accounting is a good idea in theory, but it would be extremely difficult to implement in practice.

How can some of these transition problems be overcome?

Mr. KANE. All new accounting systems are difficult to put into practice. In our lifetime, we have seen flow-of-funds accounts, input-output accounts, and national income accounts put into place. Each task was hard, but because people were determined to do it, they succeeded.

The goal is not to build a perfect system, merely a better one. To the extent that more and more assets are being traded directly and indirectly in secondary markets, it is becoming easier and easier to assign market values to the bulk of an institution's assets and liabilities. There always will be some difficult valuation problems. But these can be worked out by assigning them to an industry self-regulatory group that develops standards. Much of the difficulty is a standard-setting and enforcement problem.

A 9-PERCENT CAPITAL STANDARD

Senator PROXMIRE. Mr. Horvitz, you first proposed a 9-percent capital standard with 3-percent subordinated debt last year, as I recall.

Mr. HORVITZ. It goes back a few years.

Senator PROXMIRE. Well, at any rate you are a prophet.

You have heard Mr. Keefe arguing that there is no way that small community banks can raise the additional subordinated debt in the market.

How do you respond to that?

Mr. HORVITZ. I think the small banks have a manageable problem. They could sell such instruments within their own community

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over the counter to local businessmen or within their own board of directors. Because those institutions are smaller, the amounts we are talking about are relatively small.

I think that is a more difficult problem for the medium-sized bank that is too big to sell on a local basis. But I think there will be institutions that would respond to that. Insurance companies and others would respond to the opportunity to make good investments if there were a large volume of such instruments that were going to be able to be available in the market.

I have some confidence in the ability of the market to come up with a device to make a market for that instrument if it existed.

Senator PROXMIRE. Very good.

Well, I want to thank both of you gentlemen. Your testimony was excellent, and I regret that we had to continue so long. But you did a fine job.

Thank you very much.

The committee stands adjourned.

[Whereupon, at 1:20 p.m., the committee was adjourned, subject to the call of the Chair.]

[Response to written questions from Edward J. Kane and Paul M. Horvitz follow:]

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ANSWERS TO ADDITIONAL QUESTIONS SUBMITTED BY SENATOR JAKE GARN

Edward J. Kane
Ohio State University

1. Should a federal insurance agency be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed institution with any profit after administrative costs arising from the transaction returned to the orginal stockholders?

Answer to Question 1

Although I support this proposal in principle, three important qualifications need to be incorporated. First, "economic insolvency" needs to be defined properly. Economic insolvency occurs when the market value of net assets including all off-balance-sheet items -- less the capitalized value of federal guarantees is negative. If the criterion for insolvency turns on net asset values measured in terms of historical cost, neglecting off-balance-sheet sources of value and the value of federal guarantees, opportunities for economically insolvent institutions to operate will fail to be eliminated. Second, stockholders of near-insolvent firms should be given the option to inject new capital into the institution (i.e., to outbid other parties for the firm). Third, it must be understood that deposit insurers' enhanced takeover rights should be introduced as part of a balanced package of reforms focusing on the information, monitoring, regulatory-response, and incentive subsystems that make up the key links in the deposit-insurance chain. Complementary reforms should restructure incentives so as to upgrade the strength of the chain as a whole, thereby lessening the need to resort to temporary nationalizations of deposit institutions.

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2. If the burden of mismanagement were placed squarely on the managers and stockholders and most failures were handled through a purchase and assumption at an earlier stage - immediately or through a conservatorship - regardless of size - wouldn't this dispose of the fairness question as it relates to large and small institutions? Why couldn't a Continental type solution be applied to failing small banks? If an insurance agency is funded totally by institutions is there a federal subsidy?

Answer to Question 2

Far from hanging together, these questions get in each other's way. The hypothetical condition posed in the first question is severely weakened by the absence of the words "payoff" and "modified payoff," by the presence of the word "most," and by the danger that the criterion for insolvency would not be the economically appropriate one. Political and bureaucratic incentives produced a partial bailout of the stockholders and creditors of the Continental Illinois bank's holding company and a full bailout for uninsured creditors of the bank. Authorities' reluctance to impose losses on the uninsured creditors of a large institution cannot be wished away by adopting a vague formula for action. The limited number of potential acquirers for large institutions makes even a temporary nationalization of such institutions hard to unwind. It would be a tragedy if the government were to own and control a substantial segment of the deposit-institution industry for an extended period of time.

Extending "Continental-type solutions" to smaller failures strikes me as a recipe for disaster. If the government routinely takes options on the majority of failing firm's stock and appoints new institutional managers, our nation will end up with a growing nationalized segment of the financial industry, whose inefficient operation will cry out for regional and then nationwide consolidations that would serve to cement the nationalization.

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Finally, I regard the last portion of the question as a rhetorical non sequitur. The subsidy in deposit-insurance system flows from weakness in its information, monitoring, regulatory-response and incentive subsystems. In normal usage, the phrase "funded totally" does not encompass the full range of changes that need to be made. The heart of the problem is that insurance reserves reach far beyond the reserves that have been explicitly accumulated to back up agency liabilities. They include the taxing and regulatory powers of the federal government as a whole. After the fact, the costs of unwinding deposit-institution insolvencies can be visited on any party in the economy.

3. What can be done to prevent covenants in subordinated debt agreements from requiring the FDIC to prevent losses to all creditors as well as the holding company?

Answer to Question 3

I would urge Congress to pass a law declaring all covenants that effectively abridge deposit insurers' takeover rights to be null and void.

4. Is there a place for self-regulation in the banking industry that draws on the talent within the industry? If so, how could concepts of self-regulation be included in the federal supervisory system?

Answer to Question 4

For several years, my research has emphasized the advantages of introducing more self-regulation into the deposit-institution industry. The principal barrier to the entry of self-regulators into deposit-institution regulation is the tying of the subsidies in explicit and implicit federal guarantees to the acceptance of federal regulation.

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5. What is your view of Mr. Keefe's suggestions that

   a. The current loan limit is too high?

   b. Many banks fail due to excessive concentration?

   c. A bank be required to list its 30 largest borrowers by type of company?

   d. The largest banks be required to supply regulators with monthly data?

Answer to Question 5

Mr. Keefe's last two suggestions relate to the deposit-insurance information subsystem. My own preference is not for additional scattered pieces of useful information, but for comprehensive market-value accounting, combined with electronic reporting at frequent intervals for institutions whose accounting system is computerized.

Mr. Keefe's first three suggestions focus on the causes of observed failures as opposed to the causes of observed and unobserved economic insolvencies. It is a mistake to suppose that insurance-agency losses in past failures form a representative sample of their risk exposure in the aggregate universe of economically insolvent institutions. Economically insolvent institutions that avoid notorious or abusive behavior have usually been able to remain in operation. Nevertheless, whenever institutional portfolios are concentrated in a few credits or a few types of credits, problems with these credits can easily lead to corrupt or at least imprudent behavior.

6. Should CPA audits be required of all depository institutions and their holding companies? What steps, if any, should be taken that would permit federal bank examiners to place more reliance on auditors' evaluation of management systems and controls? Would this help examiners focus on asset quality, and bank risk levels, etc.?

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Answer to Question 6

In my view, the problems in the information and monitoring subsystems are an inappropriate focus on acquisition costs rather than market values, neglect of so-called off-balance-sheet activities, and an insufficient emphasis on fraud detection. Unless these elements are changed, increasing the resources spent on audit activity promises to yield a small return.

7. Would you recommend that federal depository agency personnel be exempted from government pay ceilings? If so, how can this be effectuated?

Answer to Question 7

I would exempt all agencies from these ceilings. These ceilings' benefits are mainly symbolic, while their costs are all too real. They lead to circumventive use of "bonuses" for favored employees and serve to drive the government's most talented and most energetic employees into the private sector. They turn regulatory agencies into finishing schools for the firms they regulate.

8. What is your view of permitting federal regulators to require institutions to pay special assessments for the increased examinations made necessary by their classification as a problem institution?

Answer to Question 8

I would require every institution to pay all costs of examination. Such costs can be interpreted as a form of risk-rated premiums, in that the increases in a firm's size, complexity, or recognized exposure to losses multiply the due-diligence effort required of its guarantors.

9. If regulators are rarely surprised by a bank failure - isn't the answer swifter or more appropriate regulatory action rather than increased market discipline?

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Wouldn't giving the regulators the ability to close an institution earlier be appropriate? Should a regulator require bank management to file a confidential bank failure plan approved by its board of directors if it falls a certain percentage below its minimum capital level for a specified period of time?

Answer to Question 9

I can't understand why one wouldn't want to use regulatory and market discipline in complementary fashion. Moreover, giving regulators more power is not going to change their behavior unless the incentives regulators confront are also changed. The rapid turnover of agency heads and their desire to avoid political and economic embarrassment on their watch impart considerable myopia to their decision-making. By and large, it pays an agency head to let emerging problems fester rather than to confront them in timely fashion.

10. What percent of total bank earnings are paid in deposit insurance premiums each year? Has this percentage gone up or down over time? Is there much variance banks to bank or by size of institution?

Answer to Question 10

This question could be answered far more easily by insurance-agency personnel, who should have the necessary information on computer tape. However, to an important extent, it is the wrong question. It looks at gross costs, rather than at insurance costs net of insurance benefits. Clearly, events have strengthened the impression that some banks are too large to liquidate. This has increased net benefits to large banks and S&Ls.

11. There appears to be strong support for required risk-based capital - as a method of calculation of capital or as a supplement to the flat rate capital ratios.

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Would this necessarily lead to higher capital standards? Is there any need for legislation in this area if such risk-based standards were to be applied equally to all institutions?

Answer to Question 11

For some reason, the industry has always regarded risk-based implicit premiums (which have been in place for decades) as more welcome than risk-based explicit premiums. In principle, the same informational problems and opportunity costs ought to arise in both approaches. This leads me to suppose that the industry believes that it can circumvent implicit premiums more easily than explicit ones.

Whether risk-based capital requirements would lead to higher capital standards depends on which complementary reforms are adopted in the other deposit-insurance subsystems. I think that it would be a mistake for society to put all its chips on this type of reform. Unless m arket-value information is developed for bookable and off-balance-sheet items alike and market-value concepts of solvency are enforced, risk-based capital requirements promise merely to employ a new brand of the same generic regulatory medicine that has proved increasingly ineffective over the last twenty years.

12. In 1981 and 1982, the banks and thrifts were suffering from disintermediation -- their better customers were flocking to money market funds in droves. Now the concern seems to be that the higher quality loan customers are able to fill their needs elsewhere. The banks point to commercial paper, and the securitization of their loan portfolio. They claim that this trend is being caused in part by their capital ratios and reserve requirements. What is your view? What recommendations do you have for us in this area?

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Answer to Question 12

A full answer to this question would take me many pages. Let me content myself with two points.

First, it is disingenuous of banks and thrifts to claim that commercial paper and loan securitization are bypassing deposit institutions because of capital and reserve requirements. These forms of bypass are, to a large extent, encouraged by banks and thrifts that are willing to provide purchasers with back-up guarantees of timely payment of the cash flows that the bypass instruments promise. As long as deposit insurers effectively insure institutions rather than deposits, guarantees marketed by banks and thrifts emerge as a way for these institutions to lever their conjectural government guarantees. The capital and reserve requirements that banks and thrifts complain about merely cut the margins that an aggressive institution can earn by arbitraging its guarantee in this way.

Second, the benefits and costs of deposit insurance are inequitably distributed. Sufficiently well-capitalized and soundly managed institutions are asked to pay too much for the guarantee services they are offered. Meaningful deposit-insurance reform would reduce the subsidies that are currently enjoyed by some banks and thrifts and impose increased costs on others. The reformed system must be flexible enough to sort out legitimate from illegitimate complaints and to deal with them accordingly.

13. With regard to the concern that some states may have expanded banks product authorities beyond what may be prudent, can this issue be dealt with by giving the federal insurance agencies the authority to require a prudent level of capital to support that activity in order to maintain insurance - rather than giving any federal agency the authority to override a state legislature? In other words, wouldn't the adoption of risk-based capital standards go a long way toward solving this problem?

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Answer to Question 13

No. The fundamental issue is how to measure and monitor the risks that an institution imposes on deposit-insurance reserves by its activities, irrespective of whether these activities are new or traditional ones. Until this issue has been adequately settled (i.e., until the information, monitoring, regulatory-response, and other incentive subsystems have been rationalized), I don't believe that the problem can be adequately handled in this way.

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RESPONSES OF PAUL M. HORVITZ

TO QUESTIONS OF SENATOR JAKE GARN

Q. 1. Should a federal insurance agency be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed institution with any profit after administrative costs arising from the transaction returned to the original stockholders?

A. 1. The power to take control of a weak bank before economic insolvency would be very useful in minimizing insurance agency losses. But I am reluctant to grant a government agency unlimited power to take private property (i.e., bank stock) away from its owners without their consent. This is particularly troublesome where the standard for action--economic insolvency--is rather difficult to measure. That is, if the FDIC were empowered to take such action when economic net worth were, say, 2%, the range of error in calculating the fair market value of some bank assets is such that the FDIC might end up taking over a bank with an economic net worth that was, in fact, rather healthy. It may not be a sufficient protection to require that residual profits be turned back to the stockholders.

After stating my reservations, on balance I nevertheless do favor the proposal. Perhaps there could be some additional safeguards--giving the bank a short time to document that it has adequate real capital or to raise additional capital. This is one reason for a subordinated debt requirement. The FDIC could be given authority to take over the bank only after stockholders have been clearly wiped out (economic net worth below zero), but before the FDIC itself is at risk (because of the cushion provided by the subordinated debt).

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Q. 2. If the burden of mismanagement were placed squarely on the managers and stockholders and most failures were handled through a purchase and assumption at an earlier stage - immediately or through a conservatorship - regardless of size - wouldn't this dispose of the fairness question as it relates to large and small institutions? Why couldn't a Continental type solution be applied to failing small banks? If an insurance agency is funded totally by institutions is there a federal subsidy?

A. 2. The fairness issue is resolved by treating large and small banks in the same way--either by protecting all depositors in all banks, or by subjecting excess deposits in large banks to risk of loss. Clearly, a "Continental type solution," which protected all depositors could be applied to all banks. What is more interesting is whether a Continental type approach could be used with large depositors subjected to a haircut. I think that is feasible, though it may have adverse effects on the stability of deposit movements.

An insurance agency totally funded by the industry still involves a federal subsidy if there is an explicit or implicit government guarantee behind the insurance system.

Q. 3. What can be done to prevent covenants in subordinated debt agreements from requiring the FDIC to prevent losses to all creditors as well as the holding company?

A 3. We should distinguish between bank debt and bank holding company debt. Bank holding company debt is no problem if the FDIC is willing to put the bank into receivership (as was done with Franklin National Bank, resulting in loss to the holders of the holding company subordinated debt). The covenant in bank holding company debt that causes the problem is the common one that prevents disposal or restructuring of the bank stock owned by the holding company without approval of the debt holders. In a threatened failure they can refuse to approve an FDIC-arranged deal unless they are protected.

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Prospectively, the Federal Reserve could refuse to allow such covenants in debt issued by bank holding companies, or the FDIC could announce that the failure of any bank subsidiary of a holding company with such covenants in its debt will result in receivership. If such a statement is believed, bank holding companies will probably choose to omit such covenants. Such a threat by the FDIC may be sufficient to induce holders of existing debt with such provisions to modify the indenture to eliminate the problem.

It is easier to handle the problem in debt of banks. The regulatory agencies capital requirements should simply be framed so that notes that include problem covenants will not be counted towards the capital requirements. That will be a sufficent incentive to avoid such covenants.

There is no question but that these desirable changes will increase the interest cost of subordinated debt to banks. I do not believe that it will make such debt unmarketable.

Q. 4. Is there a place for self-regulation in the banking industry that draws on the talent within the industry? If so, how could concepts of self-regulation be included in the federal supervisory system?

A. 4. Self-regulation sounds good, but I do not know how to make it workable. Perhaps the industry could develop the standards to move banks toward current-value accounting.

Q. 5. What is your view of Mr. Keefe's suggestions that

a. The current loan limit is too high?

b. Many banks fail due to excessive concentration?

c. A bank be required to list its 30 largest borrowers by type of company?

d. The largest banks be required to supply regulators with monthly data?

A. 5. I do not agree that loan limits are too high, though a number of bank failures have resulted when the limits were violated. Many failures have resulted from excessive concentration, though the concentration may not be apparent in advance of the problem developing, i.e., now we know that a concentration in long-term mortgage loans is risky, as is concentration on loans to local farmers.

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The largest banks can clearly be required to report monthly to the regulators, but I am less sure about greater disclosure of borrowers. My concern relates to the privacy of borrowers, not the banks. This is more a problem for small banks than for large.

Q. 6. Should CPA audits be required of all depository institutions and their holding companies? What steps, if any, should be taken that would permit federal bank examiners to place more reliance on auditors' evaluation of management systems and controls? Would this help examiners focus on asset quality, and bank risk levels, etc.?

A. 6. I am not sure of the desirability of requiring CPA audits of all banks, and the implied reduction of examiner attention to controls and fraud. In particular, I believe that examiners should devote greater efforts to fraud detection. That is were the risk of large insurance agency losses lies. Checking that internal control policies exist is not sufficient. Someone--auditor or examiner--must find out whether the policies are being carried out. It appears that Continental had sufficient internal controls to prevent its buying large amounts of fraudulent loans from Penn Square. But the control system was ignored in the desire to build loan volume.

Q. 7. Would you recommend that federal depository agency personnel be exempted from government pay ceilings? If so, how can this be effectuated?

A. 7. Clearly federal depository agency personnel should be exempted from federal pay ceilings. But so should all federal employees. Pay ceilings do protect Congressmen and Senators from the indignity of seeing mere civil servants earn higher salaries than they do, but the cost of that protection is the inability of the government to attract and retain the caliber of people needed for important management tasks--in banking supervision and other areas. Of course, Congressional salaries should be raised as well, but that is up to the Congress. If Congress lacks the guts to deal forthrightly with that issue, there is no logical reason to impose ceilings on staff of the banking agencies, Congressional staff, or any other federal employees.

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Q. 8. What is your view of permitting federal regulators to require institutions to pay special assessments for the increased examinations made necessary by their classification as a problem institution?

A. 8. Requiring the additional costs of examination of problem institutions to be borne by those institutions is equitable and appropriate. It can be viewed as a modest start toward risk-related deposit insurance premiums.

Q. 9. If regulators are rarely surprised by a bank failure - isn't the answer swifter or more appropriate regulatory action rather than increased market discipline? Wouldn't giving the regulators the ability to close an institution earlier be appropriate? Should a regulator require bank management to file a confidential bank failure plan approved by its board of directors if it falls a certain percentage below its minimum capital level for a specified period of time?

A. 9. My answer is the same as the answer to Question 1.

Q. 10. What percent of total bank earnings are paid in deposit insurance premiums each year? Has this percentage gone up or down over time? Is there much variance bank to bank or by size of institution?

A. 10. I do not have the data available to respond to this question.

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Q. 11. There appears to be strong support for required risk-based capital - as a method of calculation of capital or as a supplement to the flat rate capital ratios. Would this necessarily lead to higher capital standards? Is there any need for legislation in this area if such risk-based standards were to be applied equally to all institutions?

A. 11. As long as banks are operating with their own capital, the FDIC is not at risk, regardless of how risky the bank is. What is important is that the FDIC have a means of monitoring the condition of banks, and that the banks have sufficient capital that it cannot be wiped out before the monitoring system detects the problem. Risk-based capital requirements are neither feasible nor necessary. Substantial capital requirements are a better means of protecting the FDIC. The approach I have advocated for some time consists of a capital requirement of about 9%, with 3% required to be in the form of subordinated debt of staggered maturities. I have yet to see any specific proposals for implementing risk-related capital requirements. Much of the discussion is as fuzzy as discussions of risk-related insurance premiums.

Q. 12. In 1981 and 1982, the banks and thrifts were suffering from disintermediation - their better customers were flocking to money market funds in droves. Now the concern seems to be that the higher quality loan customers are able to fill their needs elsewhere. The banks point to commercial paper, and the securitization of their loan portfolio. They claim that this trend is being caused in part by their capital ratios and reserve requirements. What is your view? What recommendations do you have for us in this area?

A. 12. In their current state, banks cannot profitably serve the very best loan customers. The top corporate borrowers are viewed by the market as better credit risks than the banks. This means that the banks cannot raise funds from the market, and relend those funds at a profitable spread to the top borrowers. Reserve requirements may contribute to this, but they are now so low that this is unlikely to be a significant problem. Capital requirements do not seem to be the explanation either. In fact, it can be argued that one reason the market sees the top corporations as better credit risks than the banks is that the banks are too highly leveraged (on a current value basis).

Q. 13. With regard to the concern that some states may have expanded banks product authorities beyond what may be prudent, can this issue be dealt with by giving the federal insurance agencies the authority to require a prudent level of capital to support that activity in order to maintain insurance - rather than giving any federal agency the authority to override a state legislature? In other words, wouldn't the adoption of risk-based capital standards go a long way toward solving this problem?

A. 13. I do not know how to relate capital requirements to participation in particular activities, and I have seen no detailed proposals along these lines. The states can expand powers for their institutions because they have no financial risk--it is the federal insurance agencies at risk. On the other hand, the federal agencies, and the Congress, may be too cautious in expanding the areas for bank operations. The best solution in my view is to require ample capital to protect the FDIC and FSLIC, but not to attempt to relate capital requirements (or insurance premiums) to particular activities.

Q. 14. Mr. Isaac has stated that a significant number of bank failures are caused by fraud other than increased enforcement actions which are being taken by the federal agencies - aren't Mr. Homan (Former Senior Deputy Comptroller for Bank Supervision, Office of the Comptroller of the Currency) and Mr. Ryan (Former Director, Division of Banking Supervision and Regulation, Federal Reserve System) right as to the importance of the ON-SITE exam to ascertain the integrity of the numbers being generated and the lack of fraud? If so, does the decrease in on-site examinations bring with it an increase in the risk of fraud? If so, how can this be corrected?

A. 14. The agencies have considerable capability to monitor the condition of banks on the basis of reports filed by the banks. But on-site examination is essential to verify the accuracyy of these reports. Some decrease in examination of well-capitalized banks with a good record and a CPA audit of internal controls may be appropriate, but generally on-site examination must be continued. Some redirection of the activities of the examiner toward fraud detection may be necessary.

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Q. 15. Even though the FDIC continues to grow, how can or should we determine if the size of an insurance fund is sufficient and will continue to be sufficient?

A. 15. There is no way to determine how large an insurance fund is necessary. I would replace the funds with a Treasury guarantee. The funds should be turned over to the Treasury, and FDIC losses should be paid out of the Treasury. This recommendation does not affect the current system of payment of premiums by insured institutions.

Q. 16. In your opinion, what are the advantages and the disadvantages of risk-based capital and risk-based premiums? Should we consider one or the other or both? Why?

A. 16. Neither risk-based premiums nor risk-based capital is a solution to the problems of the deposit insurance systems. Risk-related premiums are not theoretically sound, because risk of loss to the insurer is not closely related to riskiness of the insured institution. In several articles I have argued that risk of loss to the FDIC is related more to the failure to detect insolvency and failure to close the failed bank promptly. To reduce that risk it is important that banks and thrifts have ample capital, but there is no need to relate that capital requirement to the riskiness of the institution. Supervision, examination, and regulation remain necessary to a sound system. A risk-related premium system can contribute to reducing incentives toward risk-taking, and provides an appearance of equity that may be helpful, even though by itself it is not a solution. The proposal for limited risk-related premiums put forth by the FDIC strikes me as the best that can be done on this problem.

Q. 17. In your statement, you advocate liquidation of institutions when their "net capital" approaches zero under mark-to-market accounting.

If an institution approaches zero net worth purely because an increase in interest rates reduces the market value of the institution's investments, when is it not reasonable to let the institution continue in business in the hope that interest rates will come back down?

A. 17. The market value of an investment is the best estimate of its value. It is rarely reasonable to allow an institution to remain in business on the basis of "hope" that the market will improve. If an institution's net worth declines to zero because of a decline in market prices, the owners should have the opportunity to put up new capital in accord with prevailing capital requirements. If they choose not to do so, perhaps because they lack faith that the market will improve, the institution should be closed. Allowing the institution to remain in business, with no capital of its own at risk, is likely to lead to increased risk-taking. The last couple of years have provided strong evidence of this tendency in the savings and loan industry. Clearly, ultimate FSLIC losses would be less if institutions had been closed when their economic net worth disappeared.

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DEPOSIT INSURANCE REFORM AND RELATED SUPERVISORY ISSUES

PART I

THURSDAY, JULY 25, 1985

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, D'Amato, Hecht, Proxmire, Cranston, Riegle, Sarbanes, Dodd, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

Today, we begin our second day of hearings on the quality of bank supervision and deposit insurance reform. I am sure that one thing on which all our witnesses will be able to begin is the importance of the safety and soundness of the Nation's financial institutions. This was a central concern of the Congress when the deposit insurance system was created and it is now our responsibility as beneficiaries of that system to update it by taking into account new forces that are reshaping the financial services industry.

It's much more competitive and it has made individual institutions more vulnerable to changes. I said before that I have few preconceptions in this area; therefore, I think we are fortunate to be able to obtain the diversity of opinion that we heard on Tuesday. I anticipate similar diversity in today's testimony.

Our first witness will be Edwin J. Gray, Chairman of the Federal Home Loan Bank Board. He will be followed by a panel consisting of Dick Pratt, a fellow Utahan, former Chairman of the Federal Home Loan Bank Board, and now chairman of Merrill Lynch Mortgage Capital, Inc.; and Mr. Jay Janis, former Chairman of the Federal Home Loan Bank Board from 1979–80, and still a director of the Home Loan Bank of San Francisco.

The second panel will include an old friend, Brent Beesley, a former Director of the Federal Savings and Loan Insurance Corporation, and now chairman of the board and chief executive officer of First Charter Savings Bank in St. George, UT; Andrew Carron, vice president, Shearson Lehman Brothers and manager of their mortgage research and analysis department; and Arthur E.

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Warner, director and professor, Center for Real Estate and Urban Economic Studies, University of South Carolina.

I'd like to welcome all of our panelists here today. We will at the conclusion of each panel ask all of the panelists questions and your entire statements will be included in the record, so we would appreciate it if you would summarize them.

Senator Proxmire, do you have any opening statement?

Senator PROXMIRE. No opening statement, Mr. Chairman. I must say Mr. Gray's timing is fantastic.

The CHAIRMAN. Senator Hecht.

Senator HECHT. No statement.

The CHAIRMAN. Mr. Gray, you missed my brilliant opening statement but I'll let you read it later.

First let me ask unanimous consent that a statement by Senator Dixon be placed in the record prior to Mr. Gray's testimony.

STATEMENT OF SENATOR ALAN DIXON

Mr. Chairman, this is our second day of hearings into deposit insurance and related supervisory issues. We have an especially distinguished group of witnesses before the committee this morning. I'm pleased to have the benefit of their expertise, and to hear their analysis of the deposit insurance and regulatory system, and their recommendations for changes.

I come to these hearings with an open mind. I have not endorsed any of the numerous proprosals that have been made to change or reform aspects of our deposit insurance or regulatory systems. I do believe, however, that we must be very thorough and very careful in our analysis of questions in these areas. Deposit insurance has been very successful; it has given us a level of consumer confidence in the safety of their money in our banks and thrifts that is the envy of the world. I'm sure no one would propose any change that could even inadvertently have the result in undermining that confidence.

At the same time, I recognize that our Nation's banks and thrifts now operate in an environment that has changed dramatically since the 1930's when the basic shape of the system was first set. We now have interest rate deregulation, and many new kinds of financial services products and competitors. Policies which made sense in the thirties, or in the fifties, or sixties, may need to be changed in light of the other changes that have occurred in the financial services industry.

I congratulate the chairman, therefore, for his initiative in beginning the committee's analysis of these important questions. I think these issues need the committee's attention.

I look forward to the testimony from the expert and able group of witnesses before us today.

STATEMENT OF EDWIN J. GRAY, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD

Mr. GRAY. Thank you very much, Mr. Chairman and distinguished members of the committee. I want to first express my deep appreciation for your willingness to take up at this time the matter of deposit insurance reform.

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Frankly, I can think of no single issue which needs to be dealt with more carefully and yet more expeditiously than this one in today's depository institutions environment.

As you know, the Bank Board has studied this entire matter over the past several years and both last year and again this year we proposed legislation to the Congress which in our view could effectively deal with excessive risks in the thrift system, particularly the risk of loss to the FSLIC.

This series of hearings is particularly timely because of the continuing strains on the working reserves of the FSLIC. I have provided in the written statement to the committee a myriad of information detailing the Bank Board's ongoing concerns relative to the industry, our regulatory challenges, and the well-being of the FSLIC. I will therefore confine my attention in this summary statement to several of the Bank Board's most pressing concerns which are highlighted in my written introductory statement.

First, I want to emphasize, Mr. Chairman, the Board's continuing admiration and appreciation for the role you played as chairman of the committee in 1981 and 1982. As a result of your strength of purpose and effective leadership at that time, the Congress and the President conferred upon an ailing savings institutions industry new operating flexibility and the elbow room necessary to confront the challenges posed by a more fierce and competitive financial services environment.

BENEFITS OF THE 1982 ACT

In my own view, the provisions of the 1982 Garn-St Germain Depository Institutions Act provided flexibility in just the right proportions—as it turns out the perfect recipe—necessary for our federally chartered thrifts to move forward in their efforts to restructure their asset and liability portfolio through appropriate diversification strategies. I only wish the recipe that Garn-St Germain prescribed had been followed more closely by more of our State legislatures in their own approaches to thrift deregulation.

In limiting asset diversification to the extension of housing credit and a limited measure of commercial-type credit, while at the same time limiting direct equity investments to a traditional asset basket of activities, the Garn-St Germain Act provided an appropriate mix of both new and conventional operating authorities. The Congress found this deregulatory prescription suitable for the existing deposit insurance scheme for thrifts.

Some States chose to go beyond that and in California's case, infinitely beyond the confines established by Garn-St Germain. As a result, operating authorities for thrifts vary enormously today and the diversity which has ensued from State to State and from State to Federal savings institutions is far greater than at any time in the modern era of the industry.

Yet, in a very real sense, the FSLIC alone is called upon to underwrite the risks of loss which can and do stem in too many cases from misuse of liberal and very liberal operating authorities which have been granted to certain savings institutions in the evolving and very highly diverse universe of thrift powers that characterize today's financial landscape.

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We who head the FSLIC and have been mandated by law to safeguard the finite resources of the insurance fund have not been given the kinds of tools that private insurance carriers employ to underwrite the risk of losses to their insurance companies' reserves. We do not have the ability to price for insurance purposes the risk of engaging in any particular kind of activity.

FSLIC OFFERS ONLY ONE POLICY

What we operate is an insurance carrier which offers only one policy, a group insurance plan, in which every institution that we insure pays the same proportional premium regardless of the degree of risk of loss that any activity may pose to our insurance reserve.

By way of analogy, the skydivers and the gardeners, the crop duster pilots and restaurant waiters, those with speeding violations and those with none, the career casino gamblers and the misers, the balloonists and the sidewalk strollers, all would pay the same insurance premiums if they were members of our group insurance plan.

In the case of our FSLIC-insured thrifts, those institutions which choose to engage in relatively risky activities and support those risks with real high net worth to absorb the risk of loss and, in contrast, those institutions which decide to become real estate speculators on significantly lower net worth cushions, all pay the same proportional premiums to the FSLIC relative to their deposits.

Given the diversity of operating authorities which vary so greatly from State to State for many thrifts, and given our experience over the past several years in operating the FSLIC group insurance plan and given the potential losses and actual losses that we have seen and are seeing at institutions engaging in higher risk activities, we believe that a better way, better than our current group insurance policy, must be found to more effectively underwrite the risk of loss to the operating reserves of the insurance company that we are mandated by law to protect.

We have taken the position that in the Garn-St Germain Act that Congress determined what activities it felt were suitable for Federal deposit insurance for thrifts. Using this rationale, we believe those activities which go beyond what Congress found suitable for coverage by our FSLIC group insurance plan ought to be subject to supplementary premium pricing based on the risk of loss to the fund that such additional activities pose.

This concept then would establish groupings of activities found to be of similar risk to institutions and to the FSLIC. These activity groupings would be subject to supplementary premiums to whatever extent a thrift might choose to engage prospectively in such activities. All of the activity groupings which would be subject to supplementary risk premiums would essentially fall outside the confines of what the Congress and the President found to be suitable in the 1982 Garn-St Germain Act for Federal deposit insurance for thrifts.

The concept proposed by the Bank Board would take into account the level of net worth of an institution, the level of net worth that institution chooses to commit to activities subject to a supple-

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mentary risk premium, and on a sliding scale. Such supplementary risk premiums would be priced lower and lower the higher and higher the net worth of the institution. Again, such supplementary risk premiums would only be assessed to the extent an institution were to choose to engage in those activities which are subjected to supplementary premium pricing.

Now I recognize the natural tendency on the part of some to be very wary if not skeptical of anything which looks or sounds new. Some are naturally skeptical of so-called risk-based premium schemes. Others may think all risk premium schemes are the same. I can only tell you that the different kind of supplementary risk premium concept we have proposed is the best, and for that matter the simplest and most practical, approach we have been able to develop to underwrite the risk of loss to the FSLIC.

A major international insurance brokerage and consulting firm has reviewed the concept and has told us it is feasible. The concept does not rate an institution for risk but only groupings of activities the institution chooses to engage in. The criteria for determining and pricing the risk of loss would be objective, not subjective. The simplicity of the approach we have developed would be characterized by certain somewhat arbitrary groupings of activities which would be subjected to supplementary risk-premium pricing.

However, the fact is, the current group insurance plan that we head is the most arbitrary one of all. As I said before, the present FSLIC group insurance scheme treats every FSLIC member institution exactly the same in terms of premiums paid—high flyers, excessive risk takers, prudent managers, imprudent managers, high net worth institutions, low net worth institutions, well-run institutions, poorly run institutions—all institutions in our system pay premiums on exactly the same basis. Nothing, absolutely nothing, could be more arbitrary and indeed more unfair than our present group insurance plan.

The cost of risk could not be more unfairly allocated. Let me emphasize again, no insurance scheme could be more arbitrary or more unfair than the one we at the Bank Board now oversee. Grouping or combining certain activities based on the risk of loss and subjecting such activities to risk premium pricing can only be less arbitrary and indeed much fairer than our present group plan because institutions would at least be able to determine for themselves which activities they would pursue, knowing full well in advance what sort of risk premium they would have to pay, depending on the extent to which they wished to engage in the activity and the level of net worth held on their books.

A FAIR ALLOCATION OF COSTS

What we have sought to do is try to develop for your consideration a proposal which we believe addresses a host of important concerns, including the important role of net worth in cushioning against losses to the insurance fund, the means for taking that into account in the pricing of supplementary risk premiums, a fairer allocation of the cost of risk, and a full acceptance and recognition of the role of State-chartering authorities in granting operating powers to their own federally insured thrifts which go beyond those

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authorized by Congress in the Garn-St Germain Act, so long as such powers are subjected to proper insurance underwriting standards through supplemental premiums, and so long as all FSLIC-insured thrifts are subjected for portfolio purposes to any asset composition test Congress may choose.

This is our proposal. We recognize, of course, that there are other approaches to dealing with insurance risks and some surely have merit. I would hope that initiatives such as ours can be looked at carefully and with an open mind. I would hope that just because this approach may appear to be relatively complicated, though I believe the concept is frankly fairly simple compared to other risk-based premium approaches that I have seen, I would hope that no Member of the Congress would somehow eschew the risk-premium approach, declare victory over perceived complexity, and moved straightaway to other matters.

In my opinion, we simply must find a better way to underwrite risks. More critical perhaps in a certain sense, I believe we must find a much fairer way to allocate the cost of risks to insured thrift institutions.

When we are able to do that, then institutions will begin to see much more light at the end of the tunnel and look far more confidently to the long-range future of the FSLIC. In my view, this would go a long way to encouraging most members of the FSLIC to work together in far greater harmony to find a way to replenish the long-term reserves of our insurance fund.

I say again, and I believe this very strongly, fairer allocation of the cost of risk to FSLIC-insured member institutions is the key to the future of the FSLIC and to the far more unified and self-disciplined thrift industry of the future.

Thank you very much. I will be pleased to answer any questions the committee may have.

The CHAIRMAN. Thank you, Mr. Grar.

[The complete prepared statement and detailed statement of Chairman Gray follow:]

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STATEMENT OF EDWIN J. GRAY, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD

I. Introduction

Mr. Chairman and distinguished members of the Committee:

On behalf of my colleagues at the Federal Home Loan Bank Board, I first want to express our deep appreciation for your willingness to take up at this time the matter of deposit insurance reform.

As you know, the Bank Board has studied the entire matter in depth over the past several years and both last year and this year we have proposed legislation which, in our view, could effectively deal with excessive risks in the thrift system, and particularly the risk of loss to the Federal Savings and Loan Insurance Corporation (FSLIC).

This series of hearings is particularly timely because the strains on the working reserves of the FSLIC have continued to increase. I believe the members of the Committee are well aware of this. Therefore, I will not dwell on the fiscal particulars of the nature of the strains themselves here.

I became Chairman of the Federal Home Loan Bank Board on June 1, 1983, very shortly after a full set of regulations was set in place to fully implement the provisions of the 1982 Garn-St Germain Depository Institutions Act. I have, therefore, been the first Chairman of the agency to be called upon to deal with the challenges of the most far-reaching deregulatory initiatives to ever confront both the thrift industry and the credit, deposit insurance and regulatory apparatus we call the Federal Home Loan Bank System which governs and underwrites for insurance purposes the activities of the industry.

The experience I and my colleagues at the Bank Board have gained through the succeeding period, and the manner in which some institutions have used their new operating authorities and -- in some instances -- imprudently operated in the resulting new environment have brought home to us, in the clearest possible way, a set of general problems and the overriding need to address those kinds of problems.

A. Moving into the New Deregulated Thrift Environment

It is important to recognize that the thrift industry was thrust into the new, deregulated operating environment after having gone through its most difficult period in history. Between 1980 and 1982, some 750 thrift institutions disappeared from the rolls of the industry. The overwhelming part of this consolidation occurred through voluntary mergers, many

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between troubled and more healthy institutions. During that same period, the industry lost roughly one quarter of its net worth.

It is fair to say, then, that the industry moved into the new, deregulated environment of 1983 in a historically weakened condition. This is, of course, why the Congress, itself, determined to provide in the Garn-St Germain legislation the kind of additional elbow room necessary, on both the asset and liability side of the balance sheet, for the industry to work through what has been for many institutions a painful transition, but one which was intended to help the industry as a whole survive and play its important role in our financial system out into the future.

In my view -- and this is buttressed by the preamble to the Garn-St Germain Act itself -- the Congress believed that the industry, in order to strengthen its ability to meet its principal housing finance responsibilities, needed the ability to compete more effectively in the money marketplace for funds and to restructure its asset and liability portfolios so as to protect itself in the future against interest rate volatility, and therefore risk. The Garn-St Germain Act appropriately addressed these needs by permitting federally-chartered thrifts additional flexibility to engage in shorter-term asset instruments than those which traditionally were confined to long-term home mortgages and were funded by much shorter term liabilities. Hence, the Garn-St Germain Act granted authority to federally-chartered thrifts to engage in limited "pure" commercial and greater "commercial real estate" lending -- instruments which, again, typically are characterized by far shorter maturity structures than long-term home mortgages.

In granting these new authorities, the Garn-St Germain Act clearly intended that the thrift industry -- which had been the victim of an unprecedented profit squeeze -- should have the opportunity to pursue additional avenues of profitability through substantially greater diversification options.

The Garn-St Germain Act also established a tiered structure by which the FSLIC could alleviate pressures on the fund by rewarding interstate operating rights to any acquirers -- in or out of the savings institutions industry -- which chose through a bidding process to help lessen the cost of assistance provided by the insurance fund to facilitate acquisitions and mergers of failing thrifts and healthy institutions.

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B. Spread Cases Change to Bad Asset Cases

The 1980-82 period, which was characterized by rising interest rates and high costs of money which had to be paid by FSLIC-insured institutions, produced a situation in which long-term fixed rate mortgage assets on the books of S&Ls were yielding less than the costs they had to pay for funds. For the most part, these assets were fundamentally good. The FSLIC was able to deal with the resulting "spread" problems it faced at failing institutions effectively because the assets of these institutions were essentially sound. The costs of FSLIC payouts, while of course high in absolute terms, were handleable relative to the resources of the insurance fund because, again, the problems were primarily "spread" generated. Asset quality in these cases was comparatively good.

I say "comparatively good," because as the deregulatory scheme moved into nigh gear in 1983, and as we at the Bank Board followed the progress of the new environment into 1984, we soon began to see a fundamental change occuring in regard to asset quality at too many institutions.

Indeed, "spread" problems which predominated the thrift landscape in the early 80's have given way to a high level of asset quality problems. A high proportion of our significant supervisory cases --institutions which are insolvent or are on their way to becoming so in the next year or two -- are beset by bad assets. These are the most costly cases of all for the FSLIC to resolve, up to five times as expensive as those "spread" problems I mentioned earlier.

I began to warn, in Congressional testimony and in speeches to industry groups in late 1983 and throughout 1984 and beyond, that excessive risktaking was occuring at too many institutions and that this was leading inexorably to more and more very expensive bad asset cases. This phenomenon was taking place in an atmosphere of excessive growth in liabilities which clearly was fueling very fast asset growth at too many institutions.

C. Brokered Funds Concerns

This recognition and concern translated early on in my chairmanship to a rulemaking process which led the Bank Board and the FDIC to adopt stringent limits on access by federally-insured banks and savings institutions to third-party brokered deposits. The easy, instantaneous access to brokered money by

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institutions choosing to leverage heavily for such funds off low levels of real capital was a source of deep concern to the Board.

Unfortunately, the federal judiciary determined that the joint FDIC-Bank Board rulemaking effort exceeded our statutory authority.

D. Net Worth Distortions and Direct Equity Investments

Nevertheless, there was a strong recognition by the Bank Board early on that the kind of incredibly fast growth strategy being followed by too many institutions on a minimum net worth standard which severely distorted the true picture of an institution's net worth would combine to exacerbate the nature of the health of the industry, and especially of the FSLIC.

The Board proposed rules to phase out the distortive effects of five year averaging for regulatory net worth purposes early on in 1984. This was met by a firestorm of very heavy opposition from most segments of the thrift industry. The Board also was deeply concerned about the increasing use of direct equity investments in all manner of activities in the spring of 1984 because of the potential risks of loss, both to institutions and to the FSLIC. The Board also proposed rules to limit such risks at that time. Again, major elements of the thrift industry rose up in fervent opposition to such a rule.

The Board took these regulatory initiatives under continuing study and, in early December, 1984, reproposed both of them in somewhat different form. In the face of continuing fervent opposition by powerful segments of the thrift industry, the Board adopted a new and stronger net worth regulation and a direct investment regulation in late January of this year.

In our view, given substantial evidence that excessive growth and excessive risktaking on low levels of real capital were worsening, or could worsen, the prospects of survival for a significant number of FSLIC-insured institutions and, therefore, for the health of the FSLIC fund, these actions were justified.

These regulatory actions were taken by the insurer -- the FSLIC, which we at the Bank Board head -- as prudent insurance underwriting steps to protect the reserves of the insurance fund. The actions were honestly and sincerely taken to improve prospects for a safer and sounder industry and, therefore, safer and more sound insurance fund.

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E. Special Premium Assessment

After considerable study, the Board also determined in February of this year to exercise its authority under law to assess a special premium of 1/32 of one percent of deposits at our institutions to further replenish the reserves of the FSLIC and to slow a declining ratio of FSLIC reserves to deposits in the industry.

We acted to assess the same special premium again in May. The two special quarterly premium assessments have added roughly one half billion dollars to the fund. And we intend to continue to consider the need for additional special premiums of this type in the future.

The fact is, however, such special premium assessments -- which are assessed proportionally, relative to deposits on all FSLIC-insured institutions, irrespective of the condition or risktaking strategies of any individual institution -- represent, just as do regular yearly 1/12-of-one-percent-of-deposits premia assessed on all institutions, an unfair allocation of the cost of risk to the FSLIC.

F. The FSLIC is a Group Insurance Plan

What we have is a group insurance plan for all FSLIC-insured savings institutions. The skydivers and the gardeners, those with an abundance of speeding violations and those with none, those who have been diagnosed as terminal cancer patients and those who are in robust health, those who choose to engage in more risky activities with high real net worth to support such risks and those who determine to play "speculator" on lower net worth, all pay the same proportional premiums to the FSLIC, relative to their deposits.

This group insurance concept worked sufficiently well for many years to fully protect the insurance fund because there was far less diversity in operating authorities granted to both state and federally-chartered thrifts. For most of the post World War II period, there has been relative economic stability and lower levels of interest rate volatility.

The group insurance concept also was designed for a highly regulated thrift industry in which it was almost totally confined by law and regulatory fiat to making long-term, fixed-rate home loans. These mortgages yielded an almost certain spread over the cost of money, which also was subject to rate controls governing interest paid on deposits.

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All of that has since changed. Today, the cost of money is subjected to market rates. We have experienced substantial interest rate volatility over the past few years. Other players compete with thrifts in home lending.

Thrifts chartered by some states have been granted far different operating authorities from other states and also different from those provided under federal law for federally-chartered savings institutions. This diversity among thrift operating authorities has enabled some institutions to engage in far greater risktaking. And the potential losses and actual losses we as regulators have seen and are seeing bear out our concerns that some better way — better than the current FSLIC group insurance plan -- must be found to underwrite the risk of loss to the insurance fund we are mandated by law to protect.

G. Rationale Behind the Bank Board's Risk Premium Concept

This is why, beginning in the spring of 1984, the Bank Board proposed to the industry and to the Congress the best and most practical plan we could come up with to try to price the risk of loss to the insurance corporation for activities institutions choose to engage in.

We took the position that in the Garn-St Germain Act, the Congress determined what activities it felt were suitable for federal deposit insurance for thrifts. Using this rationale, we said we believe those activities which go beyond what Congress found to be suitable for coverage by our FSLIC group insurance plan ought to be subjected to supplementary premium pricing -- based on the risk of loss from such additional activities to the FSLIC.

This concept, then, would establish groupings of activities found to be of generally similar risk to institutions and to the FSLIC, and these activity groupings would be subject to supplementary premiums, to whatever extent a thrift might choose to engage prospectively in such activities. Again, all of the activity groupings which would be subject to a supplementary risk premium would essentially fall outside the confines of what the Congress and the President found to be suitable in the 1982 Garn-St Garmain Act for federal deposit insurance for thrifts.

The concept proposed by the Bank Board would take into account the level of net worth of an institution choosing to engage in activities subjected to a supplementary risk premium, and, on a sliding scale, such

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supplementary risk premiums would be priced lower and lower, the higher the net worth of the institution was.

Again, such supplementary risk premiums would only be assessed to the extent an institution chose to engage in those activities subject to the premium.

Those institutions choosing to confine their activities to those permitted under the Garn-St Germain Act would continue to be assessed uniform premiums relative to deposits, as is currently the case for our group insurance plan.

The different grouping of activities subject to supplementary risk premia would not be priced the same, but rather according to the risk of loss to the FSLIC.

I. Arbitrariness Issues

However, to any who might ascribe a sort of arbitrariness to combining certain activities together as part of a scheme to price the risk of loss for such activity groupings, I would have to respond that the FSLIC's present group insurance plan is the most arbitrary one of all.

The present FSLIC group insurance scheme treats every FSLIC member institution exactly the same in terms of premiums paid. High fliers, excessive risktakers, prudent managers, imprudent managers, high net worth institutions, low net worth institutions, well run institutions, poorly run institutions -- every institution in the thrift insurance system! Nothing, absolutely nothing, could be more arbitrary, and indeed unfair, than our present group insurance plan. The cost of risk could not be more unfairly allocated. The risk of loss could not be more arbitrarily arrived at than it is in our current insurance scheme.

Indeed, no insurance scheme could be more unfair or more arbitrary than the one we at the Bank Board now oversee. Grouping or combining certain activities based on risk of loss, and subjecting such activities to risk premium pricing, can only be less arbitrary than the present group plan, because institutions would at least be able to determine for themselves which activities they would pursue full well in advance what kind of a risk premium they would have to pay -- depending on the extent to which they wished to engage in the activity, and the level of net worth they held.

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That, in my view, would be substantially less arbitrary and significantly fairer than the group plan currently in place by law at the FSLIC.

J. Rating Institutions for Risk; Premium Rebates

We recognize that rating an institution itself, based on retrospective behavior, and a multitude of other factors would be a nightmare to establish and maintain for insurance purposes. We at the Bank Board have rejected that conceptual approach for assessing risk-based premiums. We are concerned that such an approach would be self-defeating because it would have the effect of charging the highest premiums on those institutions least able to pay them, driving them that much closer and probably that much faster to insolvency. Further, in our view -- insofar as thrifts are concerned -- we believe that effectively varying current regular insurance premiums through the rebate mechanism, in which institutions that are rated higher, or highest, for risk, would be rebated all or a portion of insurance premiums paid, would not materially affect the behavior of institutions because the financial stakes for them would simply not be great enough.

K. Who Should Price Risk to the FSLIC?

I recognize, of course, that some concerns exist about what entity should determine the pricing of risk. Some have expressed concern that government regulators, even if they serve in insurance capacities, should not be permitted to determine risk premium pricing. I fully appreciate that concern and I would tend to agree with it.

Frankly, with respect to the Bank Board's conceptual approach, I would propose that the Board be required to engage a separate entity to be assigned that responsibility. I would suggest that elements of the private sector, where actuarial and insurance expertise are available and do predominate, ought to make such impartial and objective risk pricing recommendations for the Bank Board in its capacity as operating head of the FSLIC. We would be the first to admit that we do not have the capacity to underwrite the risk of loss for insurance purposes through appropriate pricing, and we would be pleased to leave that task to experts who are far better trained and prepared to do so than any of us.

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L. The Sliding Net Worth Approach

We also are aware of proposals that would would, in effect, expand the universe of activities a thrift could engage in as the institution's level of net worth increased. That proposal also has considerable merit. We would point out, however, that such a scheme -- if it were truly geared to preventing risk of loss to the insurance fund -- would have the effect of overriding state-granted authorities for thrifts, for federal deposit insurance purposes. On the other hand, it would, if structured appropriately to fully cushion the risk of loss to the FSLIC through adequate real net worth requirements, accomplish many of the goals our risk premium approach seeks to obtain by protecting the reserves of the FSLIC. If the sliding net worth approach suggested by some were implemented, we would assume the Congress would continue to insist that an appropriate thriftness test be met by all FSLIC-insured institutions, in any case.

We continue to believe that the risk premium approach proposed by the Bank Board better accomodates dual thrift system concerns, in that state chartering authorities granted by state legislatures and governors would be maintained to a greater degree. As we understand some of the sliding scale net worth approaches, certain activities would be precluded if an institution failed to meet a prescribed level of net worth, even though such an activity were provided for under state law for state chartered thrifts.

M. Bank Board's Approach

In this connection, I want to say that we at the Bank Board are not prepared to stridently argue that the conceptual approach we have outlined is necessarily the best or only one which ought to be considered by the Congress. That would be arrogant and presumptuous on our part.

What we have sought to do is to try to develop for the Congress' consideration a proposal which we believe addresses a host of concerns, including the important role of real net worth in cushioning against losses to the insurance fund, and the means for taking that into account in the pricing of supplementary risk premiums; a fairer allocation of the cost of risk and the risk of loss to the fund through supplemental risk premium pricing; a recognition of what the Congress determined to be suitable activities for thrift insurance in the 1982 Garn-St-Germain Act; and acceptance of the role of state-chartering authorities in granting operating powers to their own federally-insured thrifts, so long as such powers are

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subjected to proper insurance underwriting standards through supplemental premiums, which are priced to cover the risk of loss to the FSLIC, and so long as they (all FSLIC-insured thrifts) are subjected for portfolio purposes to any thriftness (asset composition) test the Congress may choose.

N. Concerns About Inaction

In all candor, I am concerned that some in the Congress and elsewhere may be tempted to conclude that improved deposit insurance underwriting for the risk of loss to the fund, especially as it pertains to the thrift industry, is too complicated, and it therefore ought to eschewed, or that there is no effective way to deal with such risk except through the regulatory process, itself. I hope I have dealt in an open and understanding manner with some of these concerns. I would hope that no member of the Congress would be tempted, in any event to somehow declare victory over perceived complexity and go home.

O. Insurance Companies Underwrite Risk by Pricing It

The fact is, all insurance companies, if they are to long survive as operating entities, are called upon on a daily basis to deal with the risk of loss, and they do it by pricing risk.

This is why cropduster pilots, however good they may be in their profession, and whatever their track record may be, are very likely to pay higher life insurance premiums than those who serve in normal office occupations. The activity is riskier. The list of comparisons is endless.

P. The "Regulatory" Alternative to Risk Premiums

The alternative to the supplemental premium to cover the risk of loss is to underwrite risk by regulatory action. This is particularly difficult to accomplish at present from an insurance corporation (FSLIC) point of view. Intense pressures are generally brought on regulators when attempts are made to do so. Early this year, when the Bank Board proposed, and then adopted, both the net worth regulation and the direct investment regulation, members of the industry prevailed on members of the Congress to bring pressure on the Board to either withdraw or delay these regulations.

The Board did not yield to these pressures, even in the face of a resolution signed by more than half of the members of the House of Representatives.

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It is unfortunate that in its capacity as operating head of the FSLIC, with a legal mandate to safeguard the resources of the insurance fund on behalf of the public, the Board not only had to withstand very strong pressures from certain powerful segments of the thrift industry itself to carry forward its initiatives through the rulemaking process, but it also had to forebear heavy pressure directed from certain members of the Congress itself.

In my opinion, because we complied with our statutory duty to protect the fund through the only means we had -- underwriting for the risk of loss, we helped to prevent what otherwise could have become additional huge losses out into the future deriving from continued excessive growth and huge direct investments in real estate and equities.

The fact is -- and we call upon you to help us in this endeavor -- we now need the kinds of new tools necessary to better protect the resources of the FSLIC. Again, we believe our supplementary risk premium is one way to accomplish this goal.

Q. The Role of Examination and Supervision

Adequate examination and supervision are the front lines of defense for the FSLIC.

Two weeks ago, the Bank Board consummated a nearly-year long effort to transfer our civil service examiners from that system to the Federal Home Loan Banks under enabling provisions of the Federal Home Loan Bank Act and the Garn-St Germain Act. We did so because, in large part, we were unable to secure through the budget process enough examiners to accomplish the immense task of examining institutions and assets which have combined to create a $1 trillion dollar thrift industry.

Because of the initiative we took, and because salary and hiring constraints on our field examination force were removed by this action, we expect to have not the current examination force of 750 people, but rather at least 1,000 field examiners either working or in training, by the end of this year.

I want to discuss briefly here the problems which led to this action, and the reasons why the Bank Board needs the kind of hiring and salary setting flexibility to carry out its mission throughout the agency.

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First, it is excruciatingly difficult to adequately deploy only 750 examiners to dig into the books and records of more than 3,100 FSLIC-insured savings institutions -- too many of which are beset with asset quality and operating problems -- and produce truly timely and, therefore, meaningful reports for our supervisory personnel to follow up on.

In my opinion, it is almost a miracle, under the circumstances, that our field examination force has been able to do as well as it has done. Imagine, only 750 field examiners to examine a $1 trillion industry in the most difficult and trying period in the history of the savings institutions business.

Secondly, in this new and far more sophisticated era of exceedingly complex financial and real estate transactions, on-site examination at the institution is essential. We need examiners who are trained well enough, and paid well enough, not only to do the job but to stay on the job. Yet we have had a revolving door experience in which examiner turnover in our system has been 16 percent, far above the government-wide average of 11 percent for federal employees.

In some of our districts, annual turnover rates for examiners have been as high as 28 percent.

We have been paying our examiners an average of $25,000 a year for very tough jobs which keep them on the road and away from their families for weeks at a time. The entry level salary for an examiner has been less than $15,000 a year.

I've used the past tense (have been, has been) because now that we have only just been able to transfer the field examination staff out to the Federal Home Loan Banks, we except to do significantly better than before -- by raising salaries and by hiring and training as many examiners as it takes to do the job properly.

You can put this matter in better perspective if you realize that the average salary for an examiner in the Federal Reserve System approaches $39,000 -- again, compared to what ours has been, $25,000. Believe me, the problems at many of our institutions are every bit as complex as those Federal Reserve examiners have to grapple with.

I mention this because we are only now in a position to even begin to play catch-up and begin to reduce the huge yearly turnover in the field examination force while, at the same time having the ability, for

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the first time, to begin to build an examination team which will finally be able in the next several years to cope with the magnitude of complex financial transactions it must look into in its role of monitoring the safety and soundness of institutions on behalf of the FSLIC.

R. Far Greater Staffing Flexibility Needed at FSLIC

This brings me to my next point.

Our entire FSLIC staff, including clerical support, totaled at last report only 114 people. The FSLIC has a total of 25 people in its liquidation division, and assets it must dispose of, well in excess of $2 billion. While I am not familiar with the assets the FDIC liquidation division must deal with, I believe its liquidation division includes more than 2,200 employees -- or a staff 88 times greater than that of the FSLIC's liquidation division.

We are critically shorthanded to say the least. We need flexibility necessary to hire and pay salaries sufficient to halt the continuing and pernicious drain on our people -- employees who are called upon to deal with, and seek real estate workout solutions aggregating to huge sums. These are, indeed, financial stakes which can turn into substantial savings, or losses, to the FSLIC, depending on how projects are carried out. I sincerely hope you recognize our need for greater flexibility in trying to deal with severe staffing handicaps and will work to give us the helping hand -- the support and understanding necessary -- to free the FSLIC from counterproductive constraints on our ability to do the job, so we can have the best possible chance to prevent thoroughly unnecessary losses in our management of the fund, its assets, its ability to find merger and acquisition solutions and its ability to obtain and retain the number of high quality employees necessary to operate the fund effectively in the current circumstances.

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S. The Bank Board Seeks Wide Range of Acquirers of Failed Thrifts

I want to assure you that a fundamental cornerstone of the Bank Board's policy is to seek acquirers of failing and failed thrift institutions from wide sectors of the marketplace. We actively encourage commercial banks, industrial firms, insurance companies, and private investors to join in the bidding process established under terms set forth in the Garn-St Germain Act to come to the bidding table to acquire our failed institutions. On the other hand, we do not hand over interstate operating rights to any class of depository institution -- thrift or bank -- if such potential acquirers fail to demonstrate they are serious bidders. Our job, in this regard, is to save the FSLIC money.

Some commercial banks have complained that they are not wanted as acquirers. That is simply not true at all, and I want to put that thoroughly false notion to bed, once and for all. We welcome them with open arms. We also expect them to help us to help the FSLIC save money.

Let me repeat, we are not going to give away interstate franchise rights free of charge. That does not accomplish our goal at the FSLIC -- which, again, is to save the fund money. In this regard, we simply have no other choice in the matter. All we ask of acquirers of FSLIC institutions is that they be willing to operate responsibly, and play by the Bank Board's rules.

T. The Siren Song Called "Merge the Funds"

Lately, it has come into vogue with some to ascribe many of the weaknesses of the nation's financial system to the purported "inadequacy" and "deficiencies" of the FSLIC fund.

It is worthwhile noting here that there has been a consistency of view on this issue going back now more than two years by, for example, my dear friend and esteemed colleague, the Chairman of the FDIC, who seems hell bent on seeing his untiring crusade for merger become a reality.

Others have joined in this fashionable chorus line more recently.

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We on the Bank Board have rejected the notion that strains on the financial system would disappear and a perception of strength and prowess would somehow emerge triumphant if only the FDIC and FSLIC funds were merged.

First, merger of the FSLIC and the FDIC would solve nothing. The problems our most troubled thrift institutions face would not disappear. What would happen, I fear, is that the incentives currently present to deal expeditiously with significant thrift industry issues would, in fact, fade, lured by the siren song of merger and the instant false panaceas it would appear to create in the minds of some.

This is not a time to run away from the challenges posed by strains on the nation's thrift system. It is a time to address them directly and deal with them through reform and through a genuine effort by the industry and the Congress to replenish the reserves of the fund in a manner which calls upon, and relies upon, the best instincts, the courage, the leadership and the dedication of the men and women who comprise the membership of our private sector institutions in the Federal Home Loan Bank system. There are answers as to how the reserves of the FSLIC can be replenished.

But, in my view, the kind of reform necessary to assure that out into the future the cost of risk and the risk of loss will be more fairly allocated among thrift institutions is necessary in order to inspire the kind of instincts, and courage and leadership necessary to confront and resolve these uniquely thrift system problems.

Merging the two insurance funds would cut the heart out from the Federal Home Loan Bank system, and despite protestations to the contrary by my dear friend, Chairman Isaac, there would only be a moment in time, as he knows very well, before the FDIC would be demanding the right to regulate and supervise every aspect of the thrift system, while it lasted. There is evidence which clearly indicates this is what the FDIC would no doubt pursue immediately upon merger.

Thrift institutions need to know this and come to grips with it when they hear the instant panaceas mergerists postulate.

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Again, merger would solve nothing. It would merely transfer present strains on the thrift system elsewhere and remove incentives on the part of all parties to get on with reforming the thrift deposit insurance system itself.

U. Conclusion to Introductory Statement

In this introduction to the detailed statement which follows, I have sought to lift out and highlight a number of factors and issues which place in summary perspective the Bank Board's approaches and attitudes toward deposit insurance reform and related matters.

Again, we do not presume or profess to have all the answers to all the problems and challenges our thrift system faces. But, we have made, and we intend to continue to make, serious efforts to assist the Congress in its deliberations on these issues.

We hope that the detailed statement which follows also will serve to shed as much light as possible -- at least from our point of view -- on the relevant matters at hand.

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DETAILED STATEMENT OF EDWIN J. GRAY, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD

II. Detailed Statement

As I suggested in my introduction, we are at a critical cross roads now in the deregulatory process. The Garn-St Germain Act of three years ago was a historic turning point for our industry. The Federal Home Loan Bank Board, which had long sought for the industry the kind of diversification that the Act allowed, vigorously supported it, then as now. I believe that the limited expansion of investment authority in the Garn-St Germain Act has provided the additional elbowroom which thrifts badly needed to restructure their asset-liability maturity portfolio and to strengthen support for their basic home financing role in the new competitive climate of the 1980's.

But since the passage of Garn-St Germain, the environment in which federally insured banks and thrifts operate has continued to change at a dizzying pace, producing unforeseen strains on the nation's regulators. Again, reform is needed now to address these transitional pressures. As I said before, our first priority at the Bank Board is to preserve the viability of the FSLIC which underpins our industry. The "safety net" of pervasive statutory controls which formerly served to minimize the risk exposure of institutions and the FSLIC has been largely removed by asset deregulation. But we as regulators have been given no new statutory tools to deal with an infinitely more volatile risk equation.

We -- you in the Congress and we at the Bank Board -- need to jointly address this imbalance if we are to preserve a stable framework for our federally insured thrifts.

Economic and Supervisory Overview

During my tenure as Chairman, the Bank Board has identified a number of problems related to the escalating effects of deregulation on the soundness of the industry and the FSLIC.

Prior to deregulation, the thrift industry operated in a relatively simple environment in which deposits were generated from the local community at mandated rates of interest and then invested in traditional home mortgage loans. The small number of failures during this period usually involved institutions located in economically-depressed areas that suffered from deposit outflows and substantial mortgage defaults, and occasionally from fraudulent practices.

As the restrictions on rates paid on deposit accounts were progressively lifted, competition for deposits escalated at an intense pace. In trying to preserve their core deposits in competition with institutions unburdened by low-yielding loan portfolios, thrifts were forced to pay higher rates. Both Congress and the states recognized that, in order for thrifts to

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achieve a positive spread at these higher rates, some degree of diversification from traditional home mortgage lending, including higher-yielding commercial lending, was necessary.

A number of states have also authorized significant investment levels in real estate development and other types of equity ventures.

In this deregulatory climate, many thrifts have sought to correct the earnings and capital problems triggered by the '80-'82 interest rate holocaust by exploring new investment patterns which presented greater credit risks and required more careful underwriting and profit assessment. The deregulation of investment limitations has been accompanied by additional pressure on institutions to pay higher rates to compete for funds. Moreover, the market for insured funds has become nationwide through the proliferation of deposit brokers--third parties that have enabled institutions to instantaneously access and deploy huge amounts of deposits, often in speculative, non-traditional investments. In short, managers in the last five years have come under tremendous pressure to cope with new competitive forces, and to deal with a whole new range of options and risks. While there is greater opportunity than every before, there is also far more risk and far less margin for error.

These developments, when coupled with the current flat-rate premium structure, under which the FSLIC operates, too often encourages management to adopt risky investment strategies. These deregulatory pressures have been compounded by significant constraints on in the Bank Board's supervisory authority and resources.

Despite these constraints, the Board has responded vigorously to these issues by proposing regulations as early as 1983 dealing with the risks posed brokered funds and inadequate net worth, followed by further proposed regulations on direct investments, excessive growth, net worth and proper accounting for acquisition, development, and construction loans in 1984. We have taken the extraordinary and historic step of delegating our examination duties to the Federal Home Loan Banks in order to allow the hiring of larger numbers of new examiners and the retention of skilled examiners. These steps should reduce the likelihood of future failures and should substantially reduce the cost to the FSLIC over time even if failure is unavoidable.

But these regulatory steps are by no means panaceas. They cannot change the fact that the pressures of deregulation continue to outstrip the ability of the regulatory and insurance structure to cope with the added risks inherent in a volatile deregulated environment. We need your help urgently to address these needs in four areas, to protect and enhance the FSLIC.

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These additional steps include: (1) instituting risk-based premiums; (2) providing express authority to govern FSLIC insurance for brokered deposits; (3) providing the FSLIC express authority to regulate risk-taking by insured institutions; (4) improving the Bank Board and FSLIC function by freeing the agency from constraints regarding the compensation, hiring and firing of personnel; and (5) enhancing and clarifying our enforcement powers.

Status of the FSLIC Fund

No issue is more important than maintaining the historic function of the FSLIC fund as an integral component and source of public confidence in our financial system. The thrift industry is now undergoing a difficult and fragile transition with profound implications for the FSLIC Fund. The Board believes that the legislative reforms contained in S. 759 are mandatory to modernize the fund and protect its viability, and thus the viability of the thrift industry itself. While I will discuss these reforms in detail later, I would like to start by putting our concerns about the FSLIC in perspective.

The fund is under enormous stress. Absent strong remedial action, we foresee additional strains resulting from asset quality problems and unlimited access to funds, including brokered money.

FSLIC reserves protect a deposit base that, as of December 1984, stood at approximately $785 billion. Deposits in 1984 grew by a record amount, rising $111.2 billion. By contrast, the book value of the FSLIC's reserves declined from $6.4 billion as of December 31, 1983 to $5.6 billion as of December 31, 1984. This was the first time in its history that FSLIC book reserves actually declined. This decrease resulted from the increased demand placed on the fund stemming from a growing number of severe asset quality problems at some FSLIC-insured institutions.

The book value of FSLIC reserves represents a ratio of FSLIC reserves to insured deposits which has been rapidly approaching an historic low point. Historically, the reserve ratio (total FSLIC book reserves as a percentage of total deposits) has averaged 1.2%, peaking at 2.14% in 1969. Since then, the ratio has declined sharply, falling from 0.92% at the end of the third quarter of 1984 to 0.76% at year's end. That ratio would significantly decrease if projected losses to the Fund's reserves were subtracted from FSLIC book reserves at the end of 1984.

The current reserve ratio is steadily approaching the point which prompted Congress in 1962 to impose an additional insurance premium (secondary reserve) on FSLIC-insured institutions. However, at year end 1962 the industry's ratio of

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real net worth to assets was 7.04 percent. This contrasts sharply to the current regulatory net worth ratio of 4.07 percent.

The devastating effects of interest rate spirals over the last several years were the direct result of the asset-liability mismatches that pervaded the thrift industry, putting the industry and the FSLIC Fund, which undergirds it, under strain.

Today, thrift managers have just begun to restructure their portfolios to avoid the mismatches in asset and liability maturities which resulted in losses in the 1980-1982 period. The industry's net worth fell by $7.1 billion, or 22 percent, between December 1980 and December 1982, more than three-fourths of all savings institution in the country suffered balance-sheet losses, and over 750 institutions ceased to exist. Overall industry capital fell from a ratio of net worth to assets of 5.59 percent at the end of 1979, to 4.07 percent as of May, 1985. This reflects an enormous drop from the six percent and higher ratios of the 1960s, and the first half of the 1970s.

Downward pressures on earnings and capital as a result of deeply embedded portfolio mismatch problems have continued to plague the industry. Each year from 1981 through 1983, over one-third of all thrifts reported losses. At the end of 1984, 29 percent of the industry had a ratio of regulatory net worth to total assets of less than three percent; for the year as a whole, 25 percent of FSLIC-insured institutions were still operating in the red. Net estimated income in 1984 was only $1.7 billion (including $0.6 billion resulting from the extraordinary Freddie Mac stock dividend), representing a return on assets of only 0.19 percent, a decline from the $2.0 billion income of 1983, with a return on assets of 0.27 percent. While these figures represent a significant improvement over the operating losses experienced in 1981-1982, they were sharply below the level of profits prevailing in the late 1970s when the industry was considered, by relative standards, at the peak of health.

Thrift industry profitability took a significant turn for the better early this year as a result of the sharp decline in market interest rates that took place late in 1984 and recent further declines in interest rates strongly suggests a further earnings rise in the second and third quarter of this year. Early this year, the delayed impact of the market interest rate decline last year began to be reflected in a reduction in the cost of funds for thrifts while earnings from mortgages and other investments remained relatively stable. As a consequence, the annualized return on assets for the industry during the first quarter was at an annualized rate of 0.21 percent despite the special FSLIC assessment.

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However, recent trends in rapid growth and direct investment compounded the pressures exerted on the FSLIC by the industry's earnings and capital fragility. While the Bank Board recently took action in January to address these problems through tighter capital requirements and oversight of direct equity investments, which I will discuss later, these measures alone cannot totally relieve the new strains that have appeared in the FSLIC's caseload. During 1984 we detected a very disturbing trend in the underlying reasons for failures falling on the FSLIC's doorstep. Three years ago, roughly 80 percent of FSLIC cases were primarily caused by interest-rate spread problems, while 20 percent were due primarily to asset problems. For 1984, that ratio almost completely reversed itself to 30-70 percent -- with the result that a very substantial portion of the current FSLIC caseload is characterized by bad assets.

I cannot overemphasize the importance of this shift in the nature of the FSLIC's problems. As a percent of size of problem thrifts, asset quality cases have proven to be up to five times as expensive as interest-rate spread failures for the FSLIC to resolve.

With interest-rate-spread problems, our losses were at least partially limited by the high credit quality of the underlying assets. If a prospective bidder wanted to buy one of our institutions with interest-rate spread problems, we could quantify the magnitude of the losses involved and the bidder could hedge subsequent interest-rate risk through the use of widely traded financial instruments, such as interest-rate swaps or financial futures. In the early 1980s, because of these features, FSLIC found that disposing of thrifts that failed due to interest-rate spread problems was generally practical, and could be accomplished in a way which preserved the value of a failed savings institution's franchise.

In stark contrast, our experience in working out assistance agreements when dealing with asset quality problems has proven far less encouraging. Generally, we have found that thrift institutions which have failed due to asset quality problems have often taken on a wide variety of commitments and liabilities with losses that are often difficult to quantify. The assets of such institutions usually consist largely of raw land or half-completed real estate projects. Losses are great. In dealing with asset quality failures, we have found all too often that liquidation has become the only alternative. As the FSLIC caseload has shifted toward asset problems, our actual and projected costs have increased dramatically.

As a result of the severe asset quality problems that surfaced in CY 1983 and CY 1984, the FSLIC was unable to find solutions to 15 insolvent institutions (6 in CY 1983 and 9 in CY 1984) with assets of $1.9 billion. The FSLIC was required to place these 15 institutions in receivership for purposes of

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liquidation. Prior to CY 1983, the total number of institutions liquidated by the FSLIC throughout its entire 50 year history was only 15.

In connection with liquidations that occurred in 1984, savings deposits of more than $840 million, representing 39,288 insured accounts, were immediately transferred to other FSLIC-insured institutions. The transfer of insured accounts in this manner allows insured depositors access to their accounts with minimum disruption and also enables the FSLIC to obtain a premium from the institution assuming liability for the accounts. During 1984, the FSLIC obtained premiums of more than $17.3 million on the transfer of insured accounts to FSLIC-insured institutions.

Although the FSLIC has developed more efficient and cost effective techniques and strategies for handling such receiverships, nonetheless, in 1983 and 1984, it had to use more than $1.5 billion of its resources to settle insurance on these institutions' accounts. Another half billion dollars is projected to be consumed by the losses associated with the liquidation of these institutions. This total projected cost represents nearly 50% of these institutions' total assets. By contrast, in 1982, when earnings spread problems predominated the caseload, the cost ratio of resolving 77 insolvencies was only 4%, on assets of $28 billion.

Asset quality problems also tend to occur on short notice, especially where the institution misuses easy access to brokered deposits and other funds to grow faster than sound lending practices allow. Unexpected asset quality failure leaves the FSLIC with a large operating entity and hundreds of millions of dollars of assets to manage, assess, and liquidate. The number of liquidating receiverships has increased 100% over the past 24 months, creating an urgent need for an upgraded and expanded marketing and management program of FSLIC receivership assets. Such developments are of special concern, given the current condition of the FSLIC.

Even without a significant increase in interest rates, the emerging problems now confronted by the FSLIC as a result of the growth of federally insured deposits and the disturbing upward trend in asset quality problems at some institutions make it certain that the current ratio of insured deposits of both book FSLIC reserves -- and effective, usable reserves of the Fund --will continue to drop in the future, absent remedial action. Since December 31, 1982, almost all income received by the FSLIC has been expended to solve problem cases. But during the same period, total deposits have increased from $501 billion in 1980 to $785 billion on December 31, 1984. We believe that current reserves are adequate to cover necessary cash expenditures for liquidations and supervisory mergers currently projected through the remainder of 1985. We also believe, however, that loss reserves established for payment of insurance (liquidations) and future commitments on assisted mergers or acquisitions will

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significantly impact the Fund's reseves. While it is very difficult to project with precision FSLIC reserve levels at the end of 1985, we would be derelict in our duties as managers of the FSLIC on your behalf if we failed to inform you at this time that our caseload trends do suggest the possibility that such levels could be diminished significantly, both in 1985, and again in 1986.

As a result of the projected impact on FSLIC reserves, the Federal Home Loan Bank Board assessed two special premiums of one thirty-second of a percent of deposits on individual savings institutions insured by the FSLIC in the first two quarters of this year. The need to strengthen the real, and not just the perceived, levels of the Fund was the compelling reason for the Board's decision. The assessments added roughly $500 million to the fund and additional such supplemental assessments will be imposed as necessary.

Reforming the Premium Structure

The escalating strains evident in the FSLIC's balance sheet imperil the very foundation of our financial system -- the public's confidence in federal protection for their deposits. The supplemental premiums we have assessed so far this year are no more than a temporary band-aid situation. We at the Bank Board can carry out our statutory mandate to husband the FSLIC's resources only with the aid of immediate statutory reform to permit better risk management.

The Board's legislative proposal, S. 759, contains three reforms which we believe are paramount to preserving the FSLIC's viability. Each of the three would provide the FSLIC additional flexibility absolutely crucial to deal with the unprecedented volatility and risk present in our operating environment today. These three changes would allow the FSLIC to assess a risk-based surcharge on certain activities, allow us to delineate accounts eligible for insurance, and would provide express authority to regulate risk taking by insured institutions.

Before describing these changes in detail, I would like to review the changes in the economic and regulatory climate which the Board believes have effectively rendered our current insurance structure obsolete.

As you know, the current statutes of both the FSLIC and the Federal Deposit Insurance Corporation basically provide only for premiums set at a flat rate of one-twelfth of one percent of total domestic deposits. This flat-rate insurance premium structure was designed to function in a regulatory climate where variation and magnitude of risk were not significant issues, and the Federal government did not contemplate those issues when it created these insurance funds. Today, as a result of asset and liability deregulation, thrifts have near instantaneous access to huge amounts of broker-generated funds which can be deployed over an infinite array of entrepreneurial ventures. These new

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investment opportunities present management with new challenges to their traditional experience and expertise as they seek to diversify. And investments in areas such as real estate development and commercial lending present far greater credit risks and require more sophisticated underwriting than was the case with the home mortgage portfolio. While these new opportunities present the chance for great gains, they can also produce even more spectacular losses to the institution and to the FSLIC.

In the Board's view, preserving an insurance system straightjacketed by a flat rate premium structure, which cannot account for the magnitude or diversity of risk to be incurred, while requiring the FSLIC to shoulder the enormous new risks posed by this deregulatory trend, is nothing less than a recipe for disaster. In the deregulated environment, federal deposit insurance actually encourages managers to take the biggest and riskiest gambles to obtain the highest possible returns. For a troubled institution with low or no capital, even modest risk may precipitate failure. Taking modest risks, however, would also be unlikely to restore a troubled institution to financial health quickly enough to avoid failure. Therefore, there is incentive to take greater risks which could lead to either rapid recovery or spectacular failure.

The system thus encourages a "heads I win, tails FSLIC loses" mentality for institutions which leverage heavily off low capital and take excessive risk. Financial gains are potentially enormous for stockholders and managers if an insured institution takes a big gamble and wins. But a federal agency, like the thrift insurance corporation the Bank Board heads, ends up picking up most of the cost if the gamble turns out a loser.

No insurance company, including the FSLIC, can operate successfully under such circumstances where it lacks effective tools to underwrite and to manage its risk exposure.

In my view, it is simply not rational to expect a single, federally-chartered insurance company with limited resources to insure the diversity and magnitude of risk inherent in the growing universe of operating powers in various states, especially if that insurance company cannot apply flexible standards to underwrite appropriately its reserve structure.

Over the last several years, it has also become increasingly the consensus of the policymaking community that the primary source of disequilibrium among commercial banks and savings institutions is that federal deposit insurance premia are flat, regardless of the risk assumed by different insured institutions. The natural response to this problem is to suggest that its cure is to devise a system in which either premium levels or capital requirements would be based on the institution's level of risk.

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Let me say at the outset that the concept of across-the-board risk premia or capital levels is admirable. It is fundamentally unfair that different institutions deliberately taking on different risk levels pay the same premium and face basically identical capital requirements. Clearly, our jobs at the Bank Board as trustees of the FSLIC, and the jobs of the directors of the FSLIC as well, would be far simpler and less frustrating if depository institutions that choose to take on greater risk knew they would face a considerable economic penalty in doing so.

The Board is currently engaged in a comprehensive review of the FSLIC deposit insurance system. Our fundamental sympathy with the notion behind the risk-based premium concept is evidenced by the Bank Board's legislative proposal (S. 759) to have Congress give us the authority to impose a risk-premium on the activities of state-chartered savings institutions when those institutions engage in activities beyond the powers allowed to Federally-chartered institutions in regards to St Germain. While the risk premium would not cover all of the risk exposure falling under the FSLIC's umbrella, we believe it is only fair that state-chartered institutions pay supplementary premia when they use state charters to engage in activities which, in the minds of the Congress, exceeded the appropriate boundary for a Federally-chartered institution, which the FSLIC has the statutory duty to insure under the National Housing Act. We have also consulted with industry experts regarding implementation of such a plan. While the operational details of such a proposal are not due until September, 1985, we have received a preliminary draft set of recommendations from Frank B. Hall & Co., attached as Appendix A.

The Board believes that a risk-based premium or capital level system becomes far more problematic when it is meant to apply across-the-board to the comprehensive risks imposed by all of the depository institution's assets and liabilities. Theoretically, premia and capital levels based on across-the-board risk make enormous sense. As a practical manner, however, they would be impossible to implement.

As much as we would like to, we simply cannot measure comprehensive across-the-board risk before the fact. There are two basic sources of risk facing depository institutions --interest rate risk and credit risk. Accurately measuring each poses serious obstacles.

Of the two, interest rate risk is the easiest to measure. We at the Bank Board have made enormous strides in requiring and guiding savings institutions in measuring interest rate risk. In 1984, we imposed as a requirement among savings institutions the most comprehensive asset/liability reporting requirements ever imposed by a financial regulator. Soon thereafter, we finalized a regulation requiring the Boards of Directors of savings institutions to take direct responsibility in understanding the measurement of their savings institution's interest rate risk,

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and in approving the strategy for reducing that risk. To put it simply, we at the Bank Board take interest rate risk very seriously, and our regulatory actions prove that.

Unfortunately, that does not imply that interest rate risk is precisely measurable. Residential mortgages, the primary asset of most savings institutions, prepay at dramatically different rates, depending on interest rate levels, the section of the country mortgages are originated in, where we are in the business cycle, and specific developments in housing markets. As most investment bankers and many savings institution executives understand, projecting mortgage prepayment levels precisely is an impossible task. As a result, while we can mandate the individual savings institutions make their own individual assessments of the interest rate risk they are carrying, it is difficult, if not impossible to come up with a national measurement scheme which is precise and objectively verifiable. We at the Bank Board are making enormous strides in this regard; but we have not yet arrived. At this point, a risk-related premium scheme based solely on interest rate risk is not technically achievable.

Measuring interest-rate risk is simple, however, in comparison to precisely measuring credit risk. In a dynamically changing world, it is impossible to pinpoint with precision where and to what degree risk will arise in the future. In the mid-1970's, commercial bank lending to oil well drillers was a no-lose proposition; ten years later, it is fraught with peril. Five years ago, lending for office buildings in numerous Sunbelt real estate markets was a virtual guarantee of financial success; now, in 1985, we are learning it is tremendously perilous to other than the most highly skilled lenders. Today's surefire winners can be tomorrow's worst losers. In a dynamic, growing and changing economy, new sources of both risk and return will be continually shifting.

As a consequence, however, measuring the credit risk of depository institutions with actuarial precision is virtually impossible. The only record we have is for the past. A comprehensive actuarily precise risk-based premium only makes sense if it is based on risks to be incurred in the future. Some risks, such as those taken on by life insurance companies, follow fairly steady patterns, and after-the-fact analysis can provide a fairly close indication of before-the-fact risks. For lending institutions engaged in the rapidly changing world of commerce, however, measurements of the past can only provide inprecise and often wildly correct indications of risks in the future.

It is extremely important that the members of this Committee distinguish between the Bank Board's proposal for a risk premium and the proposal for an across-the-board risk-based premium system as recommended by the previous Federal Home Loan Bank Board as well as members of the Federal Deposit Insurance Corporation (FDIC). Whereas an across-the-board risk-based

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premium system only makes sense if it measures risk with a fair degree of actuarial precision, the Bank Board's proposal is meant to impose supplements, whether actuarily precise or not, to the insurance payments of state-chartered savings institutions only insofar as they exceed the powers given to Federally-chartered institutions in Garn-St Germain. It is a narrow proposal insofar as it would only apply to some activities of some state-chartered institutions. It is a dramatic proposal in that I believe it would seriously discourage the sorts of speculative activities which account for the overwhelming majority of the thrift failures occurring at the current time, and which are imposing enormous expenses on the FSLIC. It would not discourage all forms of risk-taking, such as fixed-rate mortgage lending funded with overnight deposits, as much as we would ideally like to do so. It is, however, a feasible, equitable, and easily implemented measure which would dramatically assist the FSLIC in getting hold of the lion's share of its most pressing current problems.

In conjunction with our proposal for authority to assess a risk-based premium, the Board's legislative proposal also includes authority for the Board to assess deposit premiums on a more flexible basis than under the present annual system, or the currently authorized maximum of semiannually. This authority would, for example, permit the Board to assess premiums quarterly. This would enhance the FSLIC's resources and administrative efficiency in two important ways. First, the Board would most likely monitor a risk-based premium system on a quarterly basis, and such monitoring would more easily interface with a quarterly billing cycle. Another benefit would be accelerated premium inflows into the FSLIC during times of high deposit growth.

In short, I believe the risk-based premium concept, along with more flexible assessment authority, is essential to preserve the FSLIC fund in the form intended by Congress - as a strong and viable insurance fund the cost of which is borne by the insured institutions themselves. It is of the utmost importance that it never be necessary to call upon the full faith and credit of the United States, which implicitly stands behind the fund, to shift the burden of risk from these insured institutions to the Treasury of the United States - or ultimately, to the American taxpayer.

S. 759 also would permit the Bank Board to establish classes of insured accounts and to insure only those classes appropriate for insurance by a federal agency. We believe this enhancement of our existing statutory authority under the National Housing Act would further strengthen the FSLIC and preserve the integrity of the thrift regulatory structure. By providing such authority, the bill would insure the Bank Board the authority to prevent the diversion of deposit insurance resources to activities such as deposit brokering. The high degree of risk associated with brokered deposits -- because such funds tend to move quickly in and out of institutions, because the high rates

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needed to attract them may encourage institutions to undertake unduly risky ventures which they lack the experience and expertise to undertake, and which lead to the increasing asset quality problems I have discussed requires restricting insurance coverage on these depositors.

The Board has urgently explored regulatory changes to correct the problem of brokered deposits, but regulation is not enough.

A regulation adopted by the Board in March, 1984, which would have limited the amount of FSLIC insurance coverage of brokered deposits to $100,000 per broker per institution, was invalidated in court. At the same time that rule was adopted, the Bank Board also adopted an interim rule, limiting the amount of brokered deposits in institutions with reserves to liabilities of three percent or less to an amount equal to 5% of total deposits. The agency has subsequently acted to extend that rule indefinitely.

But this regulatory limit cannot keep pace with the potential abuse brokered funds invite; legislative reform is absolutely critical. While the 5% "cap" regulation and related supervisory monitoring have assisted in reducing the risks posed by the excessive use of brokered funds in supervisory cases, these tools simply do not address all the problems. These approaches focus only on the access of particularly vulnerable thrifts to brokered funds. They will not prevent abuses by institutions that were not of supervisory concern prior to their last examination. In addition, thrifts in desperate circumstances may be willing to violate regulations to acquire brokered funds to stave off failure. The ultimate loss borne by the FSLIC to resolve such cases will be significant. Finally, even direct supervisory efforts are often unsatisfactory in detecting brokered funds abuses because substantial brokered deposits may be acquired and invested in a very short period.

S. 759 also would explicitly empower the Bank Board to regulate risk-taking by insured institutions, thus providing added flexibility for the Board to deal with new and evolving issues and risk profiles quickly and effectively. Such a reform is an important component of our overall goal of providing the FSLIC with a comprehensive set of flexible supervisory tools to deal with a constantly changing risk equation.

Adequate Capitalization

The Board also believes that adequate capitalization of insured associations is mandatory to strengthen the ability of the FSLIC insurance company to meet its obligations and better underwrite the magnitude of risk the FSLIC must bear. Adequate capitalization helps keep risk to the FSLIC at prudent levels by proviiding a cushion against losses by individual insured institutions and by assuring accountability of thrift managers who know that their institution, not just the FSLIC, stands to

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lose as a result of excessive risk taking. In this sense, it would appear that adequate capitalization is the primary and best measure of the ability of a firm to undertake risk. A risk-adjusted insurance premium that did not have a tie-in to the firm's capital position would only partially discourage such risk-taking.

The Board has recognized in its legislative package this interplay between adequate capitalization and variable insurance rates in helping the FSLIC manage its risk exposure.

Consequently, in its legislative package, the Board proposed that variable insurance premiums shall be set by the FSLIC with regard to an insured institution's level of net worth as compared to its outstanding liabilities. Thus, for two institutions with identical portfolios, an institution with very high real net worth would pay proportionately less in supplementary premiums than the less well-capitalized entity, given the protection that very high net worth affords to cushion the risk of loss to both the institution and the FSLIC. (See the Frank B. Hall & Co. chart in Appendix A which illustrates how additional premia for non-conforming assets will vary by the net worth of the institution.)

The Board has also, by regulation, taken steps to strengthen the capitalization of individual insured institutions and the industry as a whole as a means of reducing risk to the FSLIC, thus leaving it less vulnerable to interest rate swings and changes in economic conditions generally.

The final regulation adopted by the Board in January of this year revising net worth requirements for insured institutions made three fundamental changes to prior regulations. First, the regulation amended previous regulations which exacerbated the industry's under-capitalization problems by authorizing a number of methods to compute regulatory net worth ratios which had, in effect, permitted a savings institution to meet its nominal three percent capital requirement while in fact leveraging the ratio of liabilities to net worth at levels 20 times greater than 33 to 1. Such regulations permitted a debt-to-equity ratio of up to 666 to 1, providing incredible ability to leverage. (These provisions had been adopted at a time when the industry

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was overwhelmingly mutual in form with no access to outside capital and forced to accumulate net worth via the slow process of additions to retained earnings.)

The net worth regulation also requires higher capital levels to support varying rates of increased growth. The Board's experience and studies have demonstrated that rapid growth unsupported by prudent capital levels imposes excessive risk to the institution and the FSLIC through managerial overload, creating an incentive for deliberate risk-taking, dependence on less stable funding and lack of expertise in new areas of investment. Indeed, rapid growth can so strain the managerial resources of an institution that prudent business practices and controls are not followed. Such extreme growth may also exhaust prudent local loan opportunities and lead to institutions making loans in areas where they are insufficiently knowledgeable to analyze properly the credit risk. Rapid growth often outstrips local sources of deposit and leads to dependence on "jumbo" certificates of deposit that are much less stable. Thus, as growth becomes more rapid, increasing the risks to the institution and the FSLIC, net worth requirements imposed by the regulation become greater.

The growth factor provided for in the regulation is three percent of the increase in liabilities for an institution growing at an annual rate of 15 percent or less; a graduated ratio between three and five percent of growth for institutions growing at an annual rate of more than 15 percent and up to 25 percent; and five percent of such growth for institutions growing at an annual rate of more than 25 percent. Moreover, institutions may not grow at an annual rate of greater than 25 percent without supervisory approval.

These changes ensure that higher growth -- and the risks attendant on such growth -- will be accompanied by a proportionately bigger capital "cushion" for the institution to fall back on before it lands in the lap of the FSLIC.

Finally, the rule addressed the increased riskiness of direct investment, because of its higher risk-return trade-off, by imposing an additional "contingency reserve" amount, to be added to the overall net worth requirement, equaling 10 percent of certain direct investments.

The Board has engaged in considerable research to evaluate the nature of the risk of direct investment to FSLIC and to determine whether an additional net-worth requirement is appropriate. Those studies demonstrated that greater proportions of direct investments by institutions would increase risks to them and the FSLIC Fund.

The Board's supervisory experience has also confirmed the theoretical and empirical demonstrations of the relatively riskier nature of direct investments set forth in the referenced studies. More specifically, severe losses have occurred, or

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will occur, in many institutions that have invested most heavily in direct investments (including investments that are, in economic reality, direct investments even though recorded as purported loans), at a substantial cost to the FSLIC Fund. Moreover, available data may seriously understate losses that have already occurred as a result of direct investments because expected losses resulting from poor asset quality generally do not appear on institutions' books.

These regulatory measures I have discussed on brokered funds, direct investment and net worth should aid the FSLIC in the future in averting losses stemming from inadequate capital, and poor asset quality due to excessive risk-taking. However, they are by no means panaceas. They cannot substitute for the increased flexibility urgently needed in both our insurance structure and our enforcement authority to keep pace with the challenges presented by deregulation.

Restructuring the Bank Board/FSLIC

One of the most important steps that must be taken to conserve the FSLIC's resources and ensure its continued efficiency is the restructuring of the Bank Board and the FSLIC to provide more administrative flexibility.

The Bank Board derives its name from its original responsibility: to regulate the twelve Federal Home Loan Banks, whose main function is to loan money to member thrift institutions. They are the central banks for the savings and loan industry, and they perform many of the same functions that the twelve Federal Reserve Banks perform for commercial banks.

As you are aware, the Bank Board has a number of additional duties. It controls the Federal Savings and Loan Insurance Corporation, which insures accounts in thrift institutions and parallels the duties of the Federal Deposit Insurance Corporation with regard to commercial banks and state-chartered savings banks. It charters federal savings and loan associations in much the same manner as the Comptroller of the Currency charters national banks. In addition, the Bank Board regulates and supervises the 3,191 thrift institutions under its jurisdiction.

By contrast, there are multiple agencies in Washington to regulate and supervise commercial banks. The Comptroller of the Currency charters and supervises national banks; the Federal Deposit Insurance Corporation insures the deposits of commercial and many savings banks; the Federal Reserve System regulates bank holding companies, loans money to commercial banks, and plays a large role in shaping the nation's monetary policy. These agencies, however, have received far greater flexibility to hire, fire, and compensate personnel on a competitive, businesslike basis, without obtaining OMB approval when expenditures exceed predicted levels. The new pressures bearing on the Board in this critical transitional phase of deregulation

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make a compelling case for according the Bank Board and the FSLIC flexibility equal to that of the other financial supervisors.

The Board's and the FSLIC's need for greater flexibility in administering their resources is evidenced in every aspect of their supervisory duties. For example, the expansion of state thrift asset powers has resulted in a substantial rise in requests for state thrift charters and a corresponding increase in insurance of accounts applications, which have more than doubled since 1982. In addition, the ability of the Board under the Garn-St Germain Act to charter federal associations and savings banks in either the mutual or stock form of ownership has resulted in a dramatic thirteen-fold increase of de novo charter applications since 1982. Over the past two years other application activity has continued to mirror the overall improvements in the economy. The increasing complexity of applications received for approval has required other Bank Board offices to assist the Office of District Banks in the review process. Board staff has been forced to attempt to cope with these applications without any overall increase in staff allocation from the OMB.

As I explained earlier, the deregulation of thrifts' asset and liability powers has resulted in unprecedented strains on the existing regulatory and insurance framework for thrifts. The Bank Board can continue to meet the challenges of deregulation successfully only if it is given sufficient legal authorities, administrative flexibility, and human resources to manage effectively the new tasks and risks confronting it.

New strains on the FSLIC's personnel and resources have also appeared as the result of the unprecented incentive for many thrifts to take new risks in non-traditional investments while continuing to rely on the ultimate guarantee afforded by a federal deposit insurance system which cannot take into account the diversity and quantity of risk now present in the competitive area.

The rapid increase in the FSLIC's caseload of asset-quality problems presents unique challenges to efficient monitoring and supervision. In contrast to the situation in 1980-1982 with interest rate spread problems, asset-quality problems are generally the result of imprudent management decisions made within the greater latitude allowed by deregulation. Asset-quality problem cases tend to surface on short notice, especially when an institution misuses easy access to brokered deposits to grow faster than sound lending practices permit. Moreover, unlike negative-spread problems, asset-quality problems and related fraud and mismanagement cannot be forecast with accuracy.

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Thus, detection and resolution of such problems require much more extensive on-site examination. Furthermore, the extent of asset-quality problems in poorly managed institutions and the potential for significant hidden contingent liabilities has forced the FSLIC to place many of these institutions into liquidating receiverships, which make extraordinary demands upon the Board's staff because their administration is very labor-intensive.

In fact, of the 27 cases resolved by the FSLIC during calendar 1984, 19 were asset quality problems while only 8 were interest rate spread problems. As a result of the severe asset quality problems that surfaced in calendar 1983 and 1984, the FSLIC was required to place 15 institutions into receiverships for purposes of liquidation. By comparison, the total number of institutions liquidated by the FSLIC throughout its prior 50-year history was only 15. The total projected cost to the FSLIC of these receiverships represents nearly 50 percent of these institutions' total assets. By contrast, in 1982, when earnings spread problems dominated the caseload, the cost ratio of resolving 77 insolvencies was only 4 percent of the institutions' total assets.

The number of FSLIC-supervised receiverships has increased over 500 percent in the last four years. Board staff projects that the number of active receiverships will rise to 63 by the end of 1986 -- almost an eight-fold increase in six years. The number of financial assistance cases administered by the FSLIC has expanded from 36 in 1981 to 103 by year-end 1984, an increase of almost 300 percent. And we expect that figure to increase to approximately 170 by the end of 1986. Most of these cases --and almost all cases assigned to the FSLIC during 1985 --involved asset-quality problems.

By contrast, the OMB's authorized employment level for the FSLIC has risen only 18 percent in the past four fiscal years. Despite our continued effort to realign resources, functions, and priorities, the average number of cases that must be administered by each FSLIC case manager has risen from 5 in 1981 to 17 in 1984. There has been an average shortfall of 16 percent between the OMB-authorized employment levels and our requests for each year since 1981. Not surprisingly, the FSLIC is experiencing a 33 percent turnover in personnel.

Until July 7, 1985, the Board's examiners were employees of its Office of Examinations and Supervision and, thus, were also subject to OPM and OMB restrictions. There were 750 professional and 120 clerical staff members. This level of staff was and is clearly insufficient to handle the current problems that the industry is facing. This low level of staffing resulted from the Bank Board's inability to obtain OMB approval for increasing examination staff positions.

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Compounding the inability to hire sufficient additional staff was the Bank Board's inability to compensate adequately the staff due to civil service classification problems. Bank Board examiners were paid significantly less than their counterparts at the other federal financial regulatory agencies. More specifically, the Bank Board's average examiner salary was approximately $25,000, which was $6,000 less than that of the Office of the Comptroller of the Currency, $8,000 less than the Federal Deposit Insurance Corporation, and $13,000 less than the Federal Reserve Board.

This led to significant employee turnover problems. For fiscal 1984 the field staff turnover rate was 16.1 percent nationwide. In two districts, however, the rate has been as high as 23.5 percent and 28.3 percent. With this high rate of turnover, nearly 25 percent of the field staff had less than two years of experience. In two of the districts, the trainee staff represents 27 percent and 43 percent of the staff. The high turnover rate has resulted in a less experienced staff to deal with the more complex problems which now face us. From January 1984 through June 1985, 40 percent of resigning OES professionals took jobs in the private sector, and -- even more disturbing to me -- 10 percent took positions at other federal agencies not under the same OMB and OPM constraints that we face.

While the transfer of examiners to the Federal Home Loan Bank system should alleviate these problems, the Washington staff of the Office of Examinations and Supervision (OES) is still subject to the very restrictions that formerly applied to examiners which has resulted in a turnover rate of 18.9% in fiscal year 1984. The Bank Board's staff in Washington plays a criticial role in the supervisory and enforcement process. The Assistant Directors for Regional Operations are the key reporting link between OES and the supervisory agents. OES attempts to insure nationwide consistency of interpretations of the Bank Board's regulations and disseminates information on evolving supervisory problems and national policies and approaches to meeting such problems. OES also has special accounting expertise that it makes available to examiners and supervisory agents, and it works with the FSLIC and the General Counsel in enforcement, receivership, and acquisition matters.

The Office of General Counsel has also experienced trouble retaining its attorneys, having lost 16 in the one-year period from June 1984 to June 1985. Entry-level attorneys cited improved opportunities for rapid promotions at law firms. Experienced attorneys usually joined firms either starting or expanding thrift and banking practices. A GS-14 attorney can usually receive a salary increase of 15 to 20 percent at a law firm with excellent prospects for making partner within one to two years. Two of the attorneys leaving the Board last year --and 4 the year before -- joined the Federal Home Loan Banks, which can also offer much more attractive salaries as a result of their "off-budget" status.

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As I noted earlier, the Bank Board and its staff perform for the thrift industry the chartering, insuring, supervising, examining, and lending functions performed by three federal regulators for commercial banks. Compared to these three banking agencies, however, the Bank Board is at a tremendous disadvantage. The broad outlines of the problem are thrown into stark relief by the fact that while in 1984 the three federal banking agencies together had a staff of 9,717 to regulate 14,748 institutions having total assets of $2.65 trillion, the Bank Board had a staff of only 1,467 to regulate 3,191 institutions having total assets of $1.02 trillion.

The reason for this disadvantage arises from the fact that while the three federal banking agencies are not subject to the constraints of OMB review and the appropriations process, or to civil service requirements relating to personnel and employment levels, the Bank Board is. The Federal Reserve Board, for example, is not required to submit its budget for OMB review and approval, nor is it required to receive an annual appropriation. These budget constraints sometimes result in potentially disastrous delays while the Bank Board seeks OMB approval to exceed estimated expenditures that are subject to OMB "apportionment," in trying to resolve supervisory problems which often simply cannot be "planned" or forecast with reasonable accuracy. The Federal Reserve Board is also exempted from the onerous constraints of OMB and OPM oversight of its staff resources and compensation policies.

We have searched the legislative history of our statutes in vain for a clear understanding of why the Bank Board and the FSLIC are treated differently from the banking agencies. There is simply no valid basis for the inferior status of the Bank Board compared to the other federal regulators of depository institutions. The desirability of increasing the budget flexibility of the Bank Board lies in the fact that the Board's responsibilities of regulating the nation's thrift industry, unlike those of most on-budget agencies, are a function of the economic cycle and are driven by less predictable industry crises. Thus, it is simply not logical to force it into a budget cycle designed for agencies with more routine programmatic responsibilities.

In order to relieve the budget constraints on the Bank Board arising from OMB review, I believe that the Congress should confer on both the Bank Board and the FSLIC the same independent status accorded the Federal Reserve Board and that it should enact a blanket exemption to remove the Board and the FSLIC from such approval requirements. These amendments would free the FSLIC from any obligation, as a wholly owned government corporation, to submit a budget to the OMB, and would ensure that the Bank Board itself is exempted from OMB budget approval. I believe it is also vital to enact statutory changes to remove the Bank Board and the FSLIC from the appropriations process, as well as from civil service classification requirements with respect to their personnel and employment levels and policies.

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These proposed changes are not intended to prevent Congressional oversight but, rather, to allow the Bank Board and the FSLIC the same flexibility provided the Federal Reserve Board in order to function effectively in a deregulated environment.

Supervisory case management

The Committee also requested the Board's views on a number of specific issues relating to the FSLIC's management of its supervisory caseload. As the figures noted earlier demonstrate, the FSLIC's responsibilities have grown dramatically in the last few years as the number of thrift institutions falling into FSLIC's caseload has increased. Not only has the number of cases increased, but the cost of resolving these cases has also escalated sharply. The actual relationship between the number of S&L failures and the rising costs to the insurance fund for solving these cases is more complex. Among other factors, the number of failed institutions, the method of resolution available to the FSLIC, and the timing of FSLIC actions affects the size of the ultimate insurance fund loss.

The FSLIC has a variety of options at its disposal in dealing with a troubled S&L. If an S&L fails because it cannot meet its obligations, the FSLIC must pay out to insured depositors and seek recovery through liquidation of the association's assets. Under the National Housing Act, however, the FSLIC can make loans or contributions to a failing institution, can purchase assets from the institution, or can provide assistance in any of these ways to facilitate a merger of a healthy institution with a troubled one. Normally, one or more of these combinations will prove less expensive and more feasible than the cost of liquidation.

Because of public confidence in the federal deposit insurance system, insured problem institutions rarely face dramatic outflows of deposits, even when there is general knowledge of their problems. An institution that is insolvent can sometimes operate indefinitely as far as the public is concerned. This means that it is difficult to define precisely "financial failure". In addition, the financial condition of many failing institutions deteriorates gradually, rather than as a result of a sudden shock. The FSLIC, thus, often has some latitude in timing its actions.

I. How can and should the FSLIC take action?

The losses suffered by the FSLIC depend heavily on how quickly it learns of problem institutions, the means available to it, and the skill it exercises in resolving its cases. To a large extent early intervention, and, thus, the termination of further losses by a troubled thrift, is constrained by the financial capabilities of the insurance fund. As stated before, given unlimited resources, the FSLIC has a number of methods for solving cases. The FSLIC has a series of priorities for the choice of methods, which are also linked to the timing of its actions.

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When an association has significantly depleted its net worth, a simple solution is for the owners to inject additional capital. This can be done directly or through capital markets. However, it is more feasible for stock associations than for mutuals. Unfortunately, current market conditions are not very favorable to either mutual or stock associations in the capital markets.

Capital in the institution is always the first line of defense for the insurance fund, and when sufficient capital is available there is no cost to the insurance fund. There are other solutions that require no cost to the FSLIC. If the institution is merely experiencing a temporary liquidity problem, the association's Federal Home Loan Bank can provide advances. Many more serious problems are resolved at no cost through mergers arranged by the institutions themselves. If the association is unable or unwilling, the FSLIC may be able to arrange a merger with little or no assistance. Again, this has to be done before the institution's economic net worth is completely exhausted.

Once a serious problem is recognized, the FSLIC must decide whether to keep the troubled association operating, to financially rehabilitate it, to merge or sell it, or to liquidate it. The FSLIC has a number of options in arranging mergers or sales and a variety of ways in which the association can be kept in operation.

In any case, the FSLIC must be able to demonstrate that it has the necessary grounds to take action. The statute gives the FSLIC the right to appoint a receiver for a federal association based on any one or combination of the following:

1. Insolvency, in that the assets of the association are less than its obligations to its creditors and others, including its members;
2. Unsafe and unsound condition to transact business;
3. Substantial dissipation of assets due to regulatory violations or unsafe or unsound practices;
4. Failure to disclose books and records; or
5. Willful violation of a cease and desist order which has become final.

For state-chartered, FSLIC-insured institutions the Garn-St Germain Act gave the Board the power to appoint a receiver if any one of the first three grounds listed above is present and if the state authorities consent or are given the opportunity to do so.

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Where there is no cooperation from management and/or when there are stockholders involved, a receiver is typically appointed. In the majority of cases the ground for appointment is insolvency.

Once grounds are established, the FSLIC has the clearance to take action. Its first order of priority is to reduce the cost of any assistance that is required and the method that typically produces this is outright sale or merger. An important effect of the assisted merger is that it protects all depositors of the association, not just insured depositors.

The extraordinary merger provisions of the Garn-St Germain Depository Institutions Act of 1982 also define certain priorities for FSLIC actions. When the merger offer that requires the least FSLIC assistance comes from an institution that is not an in-state insured institution or an in-state savings and loan holding company, the FSLIC must allow offerors who were within the lesser of $15 million or 15% of the initial lowest cost offer to submit a new offer. Should a reoffer result in a tie between bids, transactions are authorized in the following order of priority: between depository institutions of the same type within the same state; between depository institutions of different types in the same state; between depository institutions of the same types in different states; and finally, between different-type depository institutions in different states. In the case of minority institutions, the FSLIC must ~~seek~~ offers from other minority institutions. These re-bidding procedures can often be time consuming and discourage acquirors from submitting bids when they know they may be easily wiped out in the second round of bidding.

As stated earlier, cost is always the first priority for the solution of a case. However, of critical concern in today's environment is liquidity of the insurance fund. New techniques have been developed that allow for costs to be minimized while liquidity is preserved. One such option is the "Management Consignment Program" (MCP), where qualified, healthy institutions are called upon to assist in the stabilization and possible rehabilitation of failed associations. This program greatly reduces liquidity concerns of the fund and allows for the orderly "workout" of large FSLIC cases.

The last order of priority has always been outright liquidation. This has traditionally been the costliest solution to a case as well as the one with the worst public ramifications. Not only are liquidations costly, but they take extensive staff resources, one of the FSLIC's most precious resources.

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II. How can the FSLIC improve the cost-effectiveness of its actions?

The FSLIC has demonstrated an ability to handle massive financial problems successfully. The problems experienced today, however, are more costly, more frequent and more difficult to solve. The FSLIC must have broad legislative and regulatory powers at hand if it is going to continue to be successful. In addition, the liquidity condition of the fund has to be in such a position to allow for a multitude of solutions to occur. At present the FSLIC is working with very finite resources.

In addition to the legislative changes discussed earlier, we believe a number of other steps would increase the FSLIC's ability to manage costs more efficiently, as follows:

1. Increased clarity regarding the FSLIC's authority for appointment of a receiver for failed institutions based on a express statutory authority to further define "unsafe and unsound condition to transact business" and "substantial dissipation of assets." Section 503 of S. 759 would assist in this regard by providing the FSLIC with explicit authority to issue rules defining terms used in the National Housing Act.

2. Extension of the net worth certificate program and extraordinary acquisition provisions of the Garn-St Germain Depository Institutions Act. These are currently scheduled to expire on October 15, 1985.

3. Eliminating the priority provisions for re-bidding now required in the extraordinary acquisition process in order to encourage more vigorous competition.

FSLIC losses could be minimized by prompt closing of weak S&L's. Losses have been higher than they might have been because liquidity and staffing limitations required keeping many weak institutions in operation. On the other hand, closing many such institutions might well cause substantial disruptions in the nation's financial markets and would most certainly cause severe liquidity problems with the insurance fund. Absent enactment of the legislative reforms outlined earlier, it is impossible to predict whether the future will bring enough improvement to remedy this situation.

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III. How can the cost of managing a failure be reduced?

FSLIC has recently expanded use of the transfer of accounts method of insurance settlement and achieved significant cost savings with two new approaches.

1) Interstate Transfer of Accounts

As the size of institutions being liquidated increased, bidding for transfer of insured accounts was initiated on an interstate basis. Significantly larger discounts were received from out-of-state institutions.

	Highest In-State Bid	Highest Out of State Bid	$ Savings
San Marino	1/2 of 1%	7.1%	17 mil.
State of Utah*			25.1 mil.
Hawaii Division	None	5.6	17.6 mil.
Utah Division	1.75	8.37	7.5 mil.

*Note - A larger bid was submitted for the combined operation. However, it had provisions which were not acceptable to the Board.

2) Creation of a "New Federal"

In November 1984, the insured accounts of five Tennessee associations were simultaneously transferred into New Federal Savings and Loan Association of Knoxville, a de novo Federal association chartered solely for that purpose. This was the first time the FSLIC chartered a new institution for insurance settlement purposes. New Federal was established with assets consisting entirely of cash and FSLIC notes. New Federal was subsequently acquired in April, 1985. In this transaction which involved interstate bidding, FSLIC received a discount of 7.25% ($12 million).

IV. Should FDIC and FSLIC be merged?

The idea of merging the FDIC and the FSLIC has been discussed at length for several years. The Board is strongly opposed to such an action. We believe that such a merger would be unjustified from the standpoint of the FSLIC's financial condition, would diminish the effectiveness of thrift regulation, and would erode the long-term viability of our nation's system of specialized housing lenders.

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The two main premises for this proposed merger have been: 1) to reduce duplication, thus theoretically reducing administrative costs; and 2) to increase the security of the FSLIC fund by merging it with FDIC. We find these postulates wholly unconvincing in light of the facts.

First, the contrasting purposes and characteristics of the FDIC and the FSLIC argue strongly against a merger of the funds.

The Federal Home Loan Bank system and the Federal Savings and Loan Insurance Corporation (FSLIC) were created in 1932 and 1934, respectively to broaden the financing of home ownership opportunity; to assure millions of small depositors that they could rely upon safe, insured thrifts to hold and accumulate their savings; and to maintain the stability of the home financing and the thrift system in the face of major economic disruptions.

In contrast, the Federal Deposit Insurance Corporation (FDIC) was established in 1933 to insure all national commercial banks, to protect insured funds in the event of a commercial bank failure, and to insure the stability of the commercial banking system.

The FSLIC and the FDIC, then, were created as two separate insurance funds operating under separate and distinct regulations and serving different public needs. The history of the FSLIC fund has been inextricably linked to the financial system by its specific focus on serving housing finance in America.

To merge these two separate funds, then, would be to create a homogeneous entity to regulate two heterogeneous funds and industries.

Today, federally-insured thrifts and banks, and the regulatory structures which support them, continue to diverge markedly in terms of the functions each provides in our economy. Despite assets deregulation at the state and federal levels for thrifts, fundamental substantive differences between S&Ls and commercial banks remain, and will remain. Identifiable specialized institutions will continue to constitute the vast bulk of each of the two industries. Insurance risks, regulatory status, and assistance techniques are quite different for each industry, and will remain so given their different functions.

As such, it should also be noted that there are substantive differences between the current system for insuring S&Ls and that for commercial banks. Commercial banks are influenced by federal government policies in the areas of chartering, insurance, examination and supervision, liquidity and regulation of activities. These functions are divided among the Federal Reserve System, the Comptroller of the Currency, and the FDIC. In the case of a default prevention

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situation, action requires coordination by these three agencies, which have different objectives and different philosophies. Coordinated action is sometimes slow and difficult to achieve.

In contrast, S&Ls have all of these government functions provided by a single agency--the Federal Home Loan Bank Board. Governmental handling of default prevention cases is greatly facilitated by having a single agency with a single approach and objective in charge. To consolidate the FSLIC insurance functions into an agency with primary experience in supervising and insuring commercial lending entities would destroy this advantage with respect to S&Ls. It is also extremely doubtful whether it would eliminate any duplication since it would primarily consolidate a number of diverse activities under one agency.

The Bank Board believes that merger of the two funds without an insurance fund recapitalization program, and/or program(s) that would address the differing problems inherent in the commercial banking and thrift industries, could be regarded as a mere delaying tactic--one that would serve to postpone the demise of one fund at great expense to the other. Some proponents of a merger have labeled the FSLIC fund as the "weak sister" when compared to reserves of the FDIC. (See the chart "Average Losses to the FSLIC and the FDIC per Dollar Assets of Failed Institutions," attached as Appendix B.) This is inaccurate and misleading. Actually, the FSLIC's ratio of the fund to total deposits is higher that the FDIC's ratio, as the savings industry, unlike the banking industry, does not have a large proportion of volatile foreign deposits that are not included in the premium assessment base. As such, the FSLIC ratio is greater if the FDIC ratio is restated to include these volatile foreign deposits. Moreover, savings and loans do not have large amounts of foreign based loans in their asset portfolios.

If there were such a merger and if funds raised by the FDIC from commercial banks were used to resolve failed thrift institutions, it would seem to follow that commercial banks might wish to impose equal regulatory requirements on all insured institutions. This, in turn, would surely entail requirements which could cause thrift institutions to reduce their commitment to housing finance and require them to compete with commercial banks. This competition might radically alter the availability of long term, low cost housing finance in this country and pose a substantial threat to the continued existence of the thrift industry.

Finally, the substantive differences between S&Ls and commercial banks despite S&Ls' broadened asset and liability powers should remain. And identifiable specialized institutions will continue to constitute the vast bulk of

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each of the two industries as insurance risks, regulatory status, and assistance techniques are quite different for each industry.

Any discussion of merging the two funds would be a protracted public discussion which from the standpoint of public confidence could act to erode public faith in both the FSLIC and the FDIC.

Furthermore, from a public policy standpoint, the merger of the funds would be an indirect way by which Congress could alter its fifty-year commitment to housing finance represented by federally insured thrift institutions.

Finally, we believe it is important to note that the Vice President's Report of the Task Group on Regulation of Financial Services exhaustively studied this issue and similarly concluded in favor of retaining a separate FSLIC.

Given these considerations, the Board believes that it would be most beneficial to address the issues of insurance reform independently for the thrift and banking industries. In so doing, we will also act to preserve and build the integrity of both the federal deposit insurance funds.

The Role of Insurance in Maintaining Confidence

The final issue which the Committee asked us to address concerns the role of private insurance, and whether that role should be facilitated. While the concept of private insurance is attractive in theory, it would appear that private plans are unworkable in today's environment. Recent events in Ohio and Maryland with state-sponsored, private insurance funds have unquestionably affected the public's perception of these plans. The recent failure of these private funds also created significant instability in the financial markets. The Bank Board believes that universal federal deposit insurance is essential to maintain a sound and stable financial system in a volatile deregulated environment.

As the cornerstone of America's financial system, federally-insured depository institutions are unique private sector instruments of public policy. The very stability of our financial system is largely dependent upon public confidence in the system of banks and thrifts insured by the FDIC and the FSLIC. The nation's FSLIC-insured savings institutions are members of the Federal Home Loan Bank System, a separate and distinct credit, deposit insurance, and regulatory apparatus. Acting in its surrogate role for Congress, the system is governed by the Federal Home Loan Bank Board.

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The public policy underpinning and rationale for the Federal Home Loan Bank System were established in the Federal Home Loan Bank Act of 1932, the Homeowners Loan Act of 1933, and the National Housing Act of 1934, which created and still governs, membership in the FSLIC. Thus, this model system has served the country well for more than a half century, and, its existence has had more to do with making America a nation of homeowners than any other single factor.

Federally insured savings institutions, with their principal statutory purpose of providing home financing are the beneficiaries of a public policy with the established advantages of soliciting operating funds through marketing the FSLIC insurance seal of protection. Indeed, all federally insured depository institutions enjoy that unique advantage in their solicitation of funds with which to carry out their operations. This enables such institutions to operate on the implicit, if not explicit, full faith and credit of the United States, thereby substaining public confidence in federally insured depository institutions. By maintaining confidence in our depository institutions, the system of federal deposit insurance has served, and is serving, to support them.

To date, no insured depositor has lost a penny as the result of a failure of a depository institution that was insured by the FSLIC, the FDIC or the National Credit Union Share Insurance Fund. While the great success of federal deposit insurance has been enjoyed by more than 90 per cent of deposit-taking institutions, not all institutions have desired or qualified for federal deposit insurance. In a number of states, banks and thrift institutions have had the option of participating in private, industry-financed deposit insurance systems. Some studies estimate total deposits in such systems exceeded $30 billion at the end of 1984. The "advantage" of private insurance over federal insurance is to permit operation with less regulation and supervision, thereby allowing payment of higher rates of interest on deposits. The disadvantages were painfully illustrated recently as hundreds of thousands of depositors experienced tremendous turmoil and anxiety in the states of Ohio and Maryland. Ultimately, that turmoil -- and the panic that sparked runs on institutions throughout those states -- abated in large part only because of the ability of the federal deposit insurance agencies to quickly examine and admit to federal insurance large numbers of those privately insured entities.

One of the reasons we have federal insurance is that many depositors cannot distinguish between sound and unsound depository institutions. In assessing the degrees of financial safety, the full faith and credit of the United States offers the best credit risk, and accordingly, the best guide to institutional soundness for protection of the average depositor. Confusion over the nature of private

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insurance funds, mistakenly believed by some to be state-backed or backed by the full-faithed credit of the United States, detracts from the ability of the public to distinguish between sound and unsound institutions. The recent crises demonstrate that a person who places money in a depository institution ought to know the true nature of the insurance backing that institution, as well as the regulatory apparatus governing that insurance.

In my opinion, the public would be best protected by requiring federal insurance for all depository institutions. As the events in Ohio and Maryland recently remind us, there appears to be no adequate substitute in the minds of depositors for federal deposit insurance. Nothing has given depositors the same amount of confidence as FSLIC, FDIC and NCUSIF insurance.

Absent a statutory mandate for universal federal deposit insurance, there is every likelihood that runs similar to those in Ohio and Maryland could necessitate more ad hoc rescue efforts by the federal insurors. Universal federal deposit insurance is preferable to such a scenario for a number of reasons. While we are generally aware of some financial statistics behind the state authorized private insurance funds, we do not know the true financial condition of the thrift institutions insured by these funds. Privately insured thrift institutions are totally exempted from all federal regulations, and consequently, they are not required to report their financial condition to federal regulators not to subject their books and operations to the scrutiny o federal savings institution bank examiners. In short, these institutions have no connection with the federal government, and the federal government, in turn, has no means of assessing the financial viability of these institutions.

I should add that even a formal report on the financial condition of these institutions might not prove sufficient to assess their long-term economic viability. Analyzing financial institutions depends not only on the conditions reflected in pro forma financial statements, but also on the quality of examination and supervision those institutions receive. On a straight accounting basis, Home State Savings Bank of Ohio appeared to be adequately capitalized. On the other hand, due to what may have been lax supervision, that institution was allowed to take tremendous risk by borrowing almost 50 percent of its funds through a single government securities dealer --E.S.M.

Without our being able to scrutinize the adequacy of the examination and supervision process in states permitting private deposit insurance funds, we have no way at all of determining the soundness or financial integrity of these funds, nor can we vouch for the accuracy of the financial statistics provided by the affected institutions. In turn, with such a system of private insurance, we cannot continue

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to maintain a high level of public confidence in those institutions without federal deposit insurance nor can we prevent a fallout effect potentially draining confidence from all depository institutions for those who fail to distinguish between federal and other types of insurance.

For similar reasons, we have grave reservations that any type of co-insurance scheme with a private insurer could jeopardize the FSLIC fund. Such a regime could expose the fund to tremendous losses due to a catastrophic collapse of a private insurer. If supervision and enforcement activities of a private insurer deteriorated or failed, the FSLIC would be called upon to fulfill a fail-safe role, without adequate resources to manage and control the risk of such an occurrence.

Enforcement Legislation

Equally important to the Board's need to better supervise and stabilize the condition of regulated institutions in a deregulated environment is the need to respond effectively to problems when they are discovered. In many respects the Bank Board is hampered seriously by statutory restrictions that prevent timely action to halt regulatory violations and unsafe or unsound practices. It is for this reason that the Bank Board has proposed a series of amendments to its enforcement powers, which are included in the legislation we presented to your Committee in March of this year.

The Bank Board received its administrative enforcement authority in 1966 at the same time the banking agencies received identical authority. These provisions have been modified in a meaningful way only twice in the nearly 20 years since they were enacted, and the same modifications, with few exceptions, were also granted to the other four financial institutions regulatory agencies in the same form. The logistics of amending statutory language that affects five regulatory agencies and five sets of financial institutions, each with their own trade organizations and spokespersons, is mind-boggling.

While identical statutory language may have seemed logical to lawmakers in the past, the Bank Board believes that many of its present supervisory concerns are unique to or certainly more damaging to the thrift industry than to commercial banks. And frankly, we feel we cannot afford the luxury of waiting while four other agencies ponder whether they need similar statutory amendments. The proposals in the Bank Board's legislation are based on real problems encountered in real supervisory cases where enforcement cases were postponed or unable to be brought at all because of statutory restrictions.

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The most important provisions of our proposed enforcement amendments are the changes to our ability to issue temporary cease and desist orders. At the present time, a temporary order that is effective immediately may be issued only when the alleged violation or unsound practice charged in the Notice of Charges and Hearing is likely to cause insolvency, a substantial dissipation of assets or earnings, or a serious weakening of the financial condition of the institution. Because our statute allows an institution or individual served with such an order to challenge the temporary order within ten days in U.S. District Court, the Bank Board cannot simply state that the violation is one that may produce serious losses, it must stand ready to prove those losses at the time it serves a temporary order on an institution. This means that valuable time is lost while the Board is gathering proof of insolvency or substantial losses, even though we know that a serious problem exists at an institution. To combat this, the proposed amendments would remove the modifiers of "substantial" and "serious" before the finding of "loss" in such emergency cases.

Also proposed for our temporary cease and desist authority is a new provision to enable us to issue a temporary order to halt an institution's making of new loans or investments whenever we are unable, despite the reasonable efforts of our examiners, to determine the true financial condition of an institution because of the disarray or lack of books and records. Deficient recordkeeping has been a recurring theme in the more serious thrift failures over the last two years. It is an unfortunate by-product of the cycle of excessively rapid growth of savings deposits and the rush to place those deposits into high risk loans. The same developers and speculators who are willing to pay exorbitant fees and to commit to high interest rates are those who fail to complete applications, who do not produce adequate financial information about themselves or their proposed projects, and who are unable to produce an acceptable appraisal report. The proposed legislation would enable the Board to halt new lending to such deadbeats immediately.

To supplement its temporary cease-and-desist authority, the Board also is seeking the power to apply for injunctive relief in U.S. District Court whenever it determines that its administrative enforcement powers are insufficient to resolve serious statutory or regulatory violations or unsafe and unsound practices.

The Board also is proposing to close loopholes in its existing cease-and-desist authority that presently leave it powerless to bring enforcement actions against second-tier and partly-owned subsidiaries of insured institutions, including those that are wholly-owned by several thrifts. The amendments proposed also would clarify that the Board has the power, at the conclusion of cease-and-desist

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proceedings, to order affirmative corrective action such as restitution, rescission, the disposal of loans, and guarantees against loss.

Several changes to the Bank Board's removal and prohibition powers also have been proposed to make this authority more practical as well. It often has been said that the grounds to remove a banker or thrift official from office are stiffer than those required to convict him of a criminal offense. In many cases, this is absolutely true. Despite our strong desire to make it easier to remove the negligent or wrongdoing thrift official, we understand the need to preserve due process rights of individuals and have proposed only modest changes to our removal statute. These include: (1) a clarification of who may be removed and/or prohibited as well as when the action may be brought to avoid claims that the agency loses jurisdiction when a person resigns before a removal action is completed; (2) a removal of the modifier of "substantial" before the finding of loss to an institution in the second ground for maintaining a removal case; (3) a recognition that harm to stockholders as well as to members should be considered in removal cases; and (4) a change that makes the grounds to remove an official from a second institution for misconduct at another institution the same as the grounds for a direct removal from the first institution.

Finally, the Board has proposed to extend the industry-wide ban that presently exists for individuals who have been removed. At the present time, a thrift official removed from one FSLIC-insured institution may not serve as a director, officer, or employee of another FSLIC-insured institution, although he may work for an FDIC-insured bank or NCUA-insured credit union without penalty. The Board's legislation would make one who has been removed by an agency ineligible for reemployment by any type of insured financial institution without the prior approval of the appropriate regulatory agency.

Policy Guidelines for Each Type of Enforcement Action

Chairman Garn has requested that we address the kind of policy guidelines that should exist for each type of enforcement action. Over the years, the Board has attempted to advise its Supervisory Agents when they should seek various types of corrective actions to resolve problems encountered at insured institutions. Attached as Appendix C is a directive that I sent to the Board supervisory staff last year and Appendix D is an earlier Bank Board resolution in which one of our predecessor Board's addressed when cease-and-desist orders, as opposed to less formal actions, should be sought. All such guidelines are necessarily subjective because only human judgment can resolve these questions.

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Whether a violation of regulation deserves a cautionary letter, a supervisory agreement, or a cease and desist order depends on the factual circumstances surrounding the violation. Was it repetitive, willful, or of serious financial impact? Or was it the result of one officer's error who has since been better trained or replaced? It may be safe to say that first-time violations by institutions that demonstrate a willingness to correct problems need not result in a formal enforcement order. However, even an inadvertent violation that produces substantial financial loss may well dictate a formal rather than an informal response.

I can offer only two absolute guidelines in this respect. The first is that all significant problems and concerns revealed by examinations, monitoring efforts, or other means should be brought to the attention of the institution in a timely manner and some form of assurance that future compliance will result should be obtained. Secondly, any refusal to provide the assurance of future compliance or any significant violation of an assurance, once given, should result in the timely initiation of a more formal enforcement response.

Assessing Industry Soundness

I would also like to address briefly three issues raised in the Committee's request for testimony: assessing particular institutions' condition, assessing and predicting the likelihood of failures, and appropriate disclosure standards.

The Bank Board has taken a number of steps to improve its ability to assess the condition of the institutions which it supervises and regulates. The Bank Board has focused major attention on modernizing the examination process in the face of restrictions on the number of examiners which the Bank Board could hire and persistent examiner turnover because of salary restrictions. One example is the introduction of a new Quarterly financial reporting system and implementation of a sophisticated series of reports for use by examiners and supervisors in analyzing these data.

A particular benefit of the new Quarterly reporting system, which replaced a Semi-annual reporting system, is more timely reporting of data by institutions. As part of a monitoring process which takes place continuously in our field offices, examiners review a series of "triggers and flags" which high light associations with abnormal or substandard conditions as reflected by certain key ratios. These indicators are available from the computer within a few days after an institution submits its report.

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Complimenting the Quarterly data system is a Monthly reporting system which provides even more timely early warning of trends in association conditions, although at a much less detailed level. The Bank Board is introducing next month, in fact, a revised monthly report which will include regular reporting for the first time on changes of control and certain other non-financial but key conditions. This Monthly reporting system includes all insured institutions. This combination of Quarterly and Monthly data, new output reporting systems and procedures for continuous monitoring of these reports in all of the examination offices will, I believe, provide us with timely early warning of certain conditions warranting more in-depth on-site examiner review.

Nonetheless, we realize that financial reports from the industry cannot provide us with all of the information we need for timely warning of supervisory problems. No computer can take the place of an examiner on-site at the institution in identifying and analyzing poor loans and other quality of asset problems. In those areas requiring an on-site examiner presence, the timely discovery of problem conditions requires simply that examinations be performed more frequently, and that when conducted the scope of examination be complete. This in turn depends almost wholly on having an adequate number of examiners; properly trained and with the requisite qualifications and background.

Although prompt scheduling of examinations is crucial, it is equally crucial that the results of that examination be forwarded to Bank Board supervisory staff quickly. Here I believe the Bank Board needs to continue to emphasize to its examiners the importance of interim reporting to supervisory staff to trigger quick action. I am pleased to report that just within the past few weeks we have consolidated our examination staff and Bank supervisory staff within each of the Federal Home Loan Banks. This move will allow us to address the critical manpower shortage and high turnover that has existed in our examiner ranks. In addition, however, it will serve to improve the coordination and timely communication between our examination and supervision staffs. Those familiar with the process prior to this restructuring would agree that all too often the supervisory and examinations staff were a "house divided".

In modernizing the examination process, we also have been investigating new tools and techniques for assessing the condition of financial institutions. I mentioned already the new computer-generated reports which our staff have available quarterly. A significant feature of these reports has been the emphasis on 'gap management'. Previously, the semi-annual reporting system generated four pages of reports regarding each institution. The new quarterly system generates four pages of reports just on an institution's 'gap'. Schedule H -- the input schedule which

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the association submits -- and the output 'gap' report which goes back to the institution, I believe, have done a significant job in helping our examiners and the industry to analyze and understand clearly the risks in a mismatch of yield and maturity between an institution's interest-bearing assets and interest-bearing liabilities.

In another area, we have been exploring on a test basis across the country the usefulness of microcomputers as part of the examination process. We are in touch with the other Federal financial regulatory agencies on this to compare our experiences and to learn. Where appropriate, we are prepared to invest further in the application of this new technology not only to make the current examination process more efficient, but also to enhance the examination process in new ways.

Our ability to assess the condition of thrifts requires information. I have already discussed the new Quarterly and monthly reports which the Bank Board has or will shortly be implementing. These reports, prompt examinations and a continuous monitoring process, I believe, gives us adequate information to assess the condition of most thrifts. The Bank Board does support, however, expanded audit requirements for thrifts as an additional source of information for examiners, a source which could provide crucial early warning of problems.

A second step which we are planning to take internally to provide additional sources of information to the field is to send the Form 10Qs, 10Ks and other Securities Act filings received at the Board to our field staff as they are received in Washington headquarters. The Bank Board has jurisdiction to administer certain of the securities provisions of the Securities Exchange Act of 1934 with respect to institutions chartered by the Board or insured by the FSLIC. As a result, the Bank Board receives and reviews Exchange Act filings and has in the past coordinated that review when necessary with field staff on questions of accuracy. Supervisory staff in the field will often contact Washington securities staff to report a material development concerning an institution. The Board believes that it is now time for all of the information which comes to the Board from '34 Act filings to be shared with the field as well.

With the new information sources, a more prompt examination schedule and more complete examination scope, our staff will have the information to assess the condition of financial institutions. The new 'gap' reports have given our staff the ability to predict failures that arise from interest-rate risk. With more examiners in the field, our ability to detect poor quality of assets and predict failures because of credit risk will rise as well. Board staff also have developed a number of computer-based calculations which predict failures. Some of these are quite sophisticated, some of them are less so. They are all

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useful to a certain degree. However, given the very subjective elements inherent in balancing the many factors indicative of soundness or serious problems the Board has always relied on its field examination staff for the final determination of a potential failure.

Ability to Predict Failure

Savings and loan associations experiencing severe financial problems, which will likely involve assistance from the FSLIC, usually involve two types of problems: negative yield spreads or poor quality assets.

As I noted earlier, prior to 1983, the industry's assets consisted of residential mortgages and liabilities consisted of savings accounts, mostly under rate control, and FHLB borrowings. During this time, most problem cases were due to negative or poor yield spreads, caused by rising short-term interest rates. Monthly operating losses could be monitored off monthly reports; such losses would remain relatively constant, and would generally rise and fall with changes in short-term interest rates. In 1981, OES developed a computer-based insolvency report, based on the monthly reports submitted by all associations. The report averaged the monthly operating loss for the three most recent months, and divided the average loss into current net worth. Associations with less than 24 months to insolvency were printed on a computerized report. The computerized report was put into a monthly written report, which is still used as a monitoring device and management report by OES. Despite its simplicity, the insolvency report has been remarkably accurate in predicting failure in those associations with spread problems.

The other major problem facing the industry - poor quality assets -- poses a much greater difficulty in predicting failure. The nature of asset problems is that, once a bad loan or investment is made, very little can be done to prevent a loss; if enough bad loans and investments are made, little can be done to prevent the association's failure. With construction loans, industry practice is to pay interest out of loans-in-process during the construction period, with repayment dependent on the successful and timely marketing of the project. Clear evidence of a project's failure is usually not evident until the project is completed and not sold, usually eighteen months to two years after the granting of the loan. Typically, during an examination or audit, reappraisals are ordered or net realizable value calculations are made. Significant indicated losses will result in the request for loss reserves, which may immediately deplete the association's net worth, which may have appeared adequate before the write-downs.

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There are several indications of asset quality problems. The first is a change of business plans in which management enters a new area in which it has little expertise. Adverse comment in examination reports on underwriting, credit analysis, lack of feasibility studies, appraisal practices, and loan procedures, is an indication of problems. Due to the length of a project, it is possible for markets to change, rendering a once viable project a problem. Eventually, asset problems will be reflected on an association's earnings statement and statement of condition. A significant volume of non-earning assets will result in declining net income and losses, Real Estate Owned and delinquent loans should be reflected on monthly reports. Increasing uncollected interest also indicates a materializing problem. However, all of these indications pertain to bad loans and investments which are already on the books. The loss or failure is not really being predicted - it already exists, but may not be recognized or booked.

Given this inherent problem with predicting asset quality failures, I believe our best hope for more efficiency in this regard is to obtain the new statutory enforcement powers we have requested. While they will not avert failures in most cases, they can help us to act quickly on the warning signals of potentially serious problems provided through our routine monitoring and examinations, and thereby reduce the volume of losses to the institutions and to the FSLIC.

Disclosure

The Committee also requested our views on appropriate disclosure and differentiating between institutions through disclosure. Deciding what information to disclose to the public regarding an institution's operations, especially regarding any actual or potential problems it may be facing, requires a careful balancing of competing concerns. On the one hand, the Bank Board recognizes the public's need for information about thrift institutions. On the other, the Board wishes to prevent the instability in a particular institution, or in the industry as a whole, that can result when information is disseminated but misinterpreted. In an effort to address both these concerns, the Board has drawn careful limits with respect to the disclosure of information to the public.

For savings and loan associations and savings banks that are subject to the Securities Exchange Act of 1934 ("'34 Act") 1/ a comprehensive disclosure regime requires full disclosure of material information concerning the

1/ As of June 15, 1985 approximately 340 institutions are registered with the Bank Board under the '34 Act.

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institution to its stockholders and the investing public. The Bank Board vigorously enforces the disclosure requirements of the '34 Act with respect to the institutions for which the Board has '34 Act jurisdiction. The Board has been very successful in obtaining compliance through the use of informal directives, supervisory agreements, and cease-and-desist orders, and in virtually all cases it has not been necessary to resort to civil injunction actions in order to achieve compliance. These enforcement proceedings are not kept confidential, and it has been the Board's practice to generally disclose publicly the results of enforcement actions taken with regard to compliance with the '34 Act, as well as the Board's stock conversion regulation and Change in Control Act. In addition, the Board's Washington, D.C. staff works with the Board's network of supervisory agents to verify the accuracy of information disclosed in required reports to the Board. Thus, with respect to '34 Act institutions, the Board maintains an active program to insure that institutions make appropriate and timely public disclosures of material information and a vigorous compliance program, which includes publicity of enforcement actions taken.

All institutions the Board supervises are required to submit, on a quarterly basis, a complete balance sheet and income and expense statement including data on brokered funds, types of deposits and borrowings, outstanding mortgage loans and composition of net worth. The Board previously required this submission semi-annually but increased the frequency of reporting to quarterly in March, 1984. As in the past, the Board publishes this information in the aggregate. In addition, although the Board does not make all this data publicly available with regard to each institution, the public can obtain much of it for a small processing fee.

With respect to other types of enforcement proceedings, the Bank Board is not required to disclose information concerning cease-and-desist or removal/prohibition proceedings. Instead, these administrative proceedings are confidential unless the Board determines, after considering the views of the party afforded a hearing, that disclosure is in the public interest. 2/

2/ 12 U.S. C. §§ 1464(d)(7)(A) and 1730(j)(1) (1982).

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The Bank Board is, of course, aware of the FDIC's recently adopted policy of issuing press releases containing information about enforcement orders against state nonmember banks.3/ For the following reasons, however, the Board believes that the likely adverse effects of applying such a disclosure policy to the thrift industry would far outweigh any potential benefits.

First, broad disclosure of enforcement orders would likely lead to misunderstandings that would erode public confidence in the institution affected by an order, whether or not the order related to the institution's financial health. Many types of enforcement orders carry no implications concerning a thrift's soundness; examples of such orders include those relating to the stock conversion or proxy rules, Regulation Z disclosures to borrowers, and accounting and bookkeeping requirements for loans. Yet, consumers could easily misinterpret such an order as a sign of an institution's ill health. When consumers act on such misinterpretations by withdrawing their funds, public confidence in the institution is needlessly lost, and it suffers financially from the withdrawals.

Even when an enforcement order does concern activity that relates to a thrift's viability, the existence of the order usually means that the Bank Board has already taken effective steps to protect the institution from further harm. In such circumstances, the consumer with savings at or below the maximum amount for federal insurance coverage is insulated from loss not only by the insurance fund but by the remedial effect of the enforcement order. Ironically, publication of the remedial order may trigger a loss of public confidence in an institution at the very moment when it has begun to solve its problems. Having misinterpreted the significance of an enforcement order, consumers may shun not only the affected thrift but other thrifts in the same state, region, or market area as well. Thus, in addition to undermining the remedial purpose of an enforcement proceeding, such a misinterpretation could threaten the stability of the industry and the insurance fund to the detriment of both institutions and their depositors.

Second, a broad disclosure policy would likely discourage institutions from entering into enforcement orders by consent. Knowing that adverse publicity will result no matter what course of action it takes, an institution may well decide that it has little to lose by choosing to engage in a protracted enforcement proceeding. Of course, this result would further delay beneficial remedial action and would tax the agency's limited

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3/ Statement of Policy Regarding Disclosure by the FDIC of Statutory Enforcement Actions, 50 Fed. Reg. 20,609 (1985).

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enforcement resources. In addition, it runs counter to one goal of deregulation, which should be to encourage voluntary compliance with applicable rules whenever possible.

Finally, without assurances of confidentiality, many institutions may be reluctant to cooperate fully in providing examiners with the information necessary to complete their task. Broad disclosure will certainly encourage the industry to take a more adversarial posture with regard to its regulators. In such a climate, information will be harder to obtain. As a result, the examination process will be slower, rendering the early detection and resolution of an institution's financial problems much less likely.

In the Board's view, adequate information is already available to the public. Broader disclosure concerning sensitive financial statements and enforcement orders poses the grave risk of increasing the difficulty of the regulatory task. In a volatile, deregulated environment, it is axiomatic that we must preserve and enhance the efficiency of supervision to ensure the safety and soundness of the institutions we regulate. Ultimately, broader disclosure could undermine this goal, and seriously jeopardize the stability of the thrift industry. The Board believes therefore that it should continue to address disclosure issues on a case-by-case basis so that it may carefully balance the sometimes conflicting concerns of public disclosure and effective supervisory and enforcement actions.

CONCLUSION

In closing, I would like to highlight briefly the four issues which the Bank Board views as fundamental to preserving a sound and stable regulatory framework for thrifts.

First, it is essential to reform the FSLIC's premium structure to reduce speculative incentives and provide a fairer allocation of the cost of risk and the risk of loss to the fund. The perverse incentives for risk-taking at the FSLIC's expense -- which the current structure creates -- coupled with the unprecedented opportunity to take those risks in a deregulated environment -- will irreparably damage the FSLIC unless we have the tools to manage risk effectively.

Second, given the infinitely greater breadth and complexity of our regulatory task today, the Bank Board and the FSLIC can function effectively only if we receive greater flexibility to meet our staffing needs. The constraints now placed upon the Bank Board and the FSLIC with regard to compensation, hiring and firing make no sense in terms of administrative efficiency and put us at a

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distinct disadvantage with regard to other financial institution supervisory agencies, such as the Federal Reserve Board. We can find no rational basis for this bias given the fact that we are expected to perform for our industry the total of the duties now performed for commercial banks by the Comptroller of the Currency, the FDIC, and the Federal Reserve Board.

The third integral component of a plan to strengthen the FSLIC is the enactment of the enforcement measures included in S. 759.

And finally, we emphatically reject the notion that the option of strengthening the FSLIC should be discarded in favor of merging the FSLIC and the FDIC. The alleged benefits of such a merger, when examined closely, are wholly illusory. At the same time, it is certain that the costs of such a step would entail drastically reducing the efficient coordination of thrift regulation and supervision which the current thrift regulatory structure provides. I believe the plan I have outlined today would provide far better results in terms of strengthening our nation's financial system, and reducing the likelihood that either deposit insurance agency would have to resort to the implicit full faith and credit guarantee of the United States.

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INDEX TO ATTACHMENTS

APPENDIX A	-	Hall & Co. Letter - July 1985 on Insurance Premium Reform
APPENDIX B	-	Average Losses to FSLIC and FDIC Per Dollar Assets of Failed Institutions
APPENDIX C	-	Supervisory Agents' Letter - April 12, 1984
APPENDIX D	-	Board Resolution No. 82-381

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APPENDIX A

Frank B. Hall & Co., Inc.
Hall Services Division
549 Pleasantville Road
Briarcliff Manor, New York 10510

July 19, 1985

Chairman Edwin J. Gray
Board Member Donald I. Hovde
Board Member Mary A. Grigsby
Federal Home Loan Bank Board
1700 "G" Street, N.W.
Washington, D.C. 20552

Dear Board Member:

We have been asked to comment on the practicality of introducing a variable rate premium structure for FSLIC insured institutions. In particular, we have been requested to recommend a structure of additional premiums for assets which are beyond those permitted by the Homeowners Loan Act.

In determining the feasibility of an asset based risk sensitive insurance rating plan for the FSLIC, we have relied on certain fundamental considerations as presented in the American Academy of Actuaries "Risk Classification - Statement of Principles" published in June of 1980. These include:

1. "To the extent that the risk classification process attempts to identify and measure every characteristic, it becomes unworkable. On the other hand, because there are differences in risk characteristics, to ignore all such differences would be unfair." The last point above indicates the need for change in the current system of FSLIC insurance rates. The first point indicates that using those characteristics with the greatest impact is useful, but to try and include all relevant factors is not productive. Changes in the underlying risk elements over time frequently have a much greater impact on the amount of gain or loss to an insurance fund than selecting a factor that has a minor impact on the premium calculations. This is particularly true when losses can fluctuate widely due to changes in broad economic conditions such as the rate of inflation.

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2. "In insurance, it is often impossible to prove statistically any postulated cause and effect relationship. Causality can not, therefore, be made a requirement for a risk classification system".

   In fact, postulated cause and effect relationships frequently come after differences in losses are observed. Red cars historically have higher losses than average. Once this is observed a variety of postulates concerning the psyche of people who own red cars have been made. This aspect of risk classification causes particularily difficult situations when variables such as sex, race, religion or age have been used. This issue may be an area of concern for this program.

3. "The classification of risks in order to group those with similar risks characteristics is fundamental to any true insurance system." This implies that the classes used should attempt to have as little variation as possible in risk within the class and as much variation as possible between classes.

Within the context of the considerations described above, we have viewed the FSLIC as an underwriter who must make judgements on the relative riskiness of certain activities without a complete base of historical data. Further, the FSLIC is constrained to the extent that it cannot refuse insurance to those thrift institutions whom it judges to be more risky. The only alternative, then, which is consistant with sound underwriting practices, is to charge additional premiums for those activities which are viewed as more risky.

With the above precepts in mind, it is our belief that an asset based risk sensitive insurance rating plan can be developed for the FSLIC which will:

(1) Improve on the current flat rate structure.

(2) Take into consideration the FHLBB and FSLIC evaluation of the relative riskiness of activities which are beyond the scope of the Homeowners Loan Act.

(3) Be structured so that greater statistical precision will be obtained over time as increased data become available concerning activities that extend beyond the Homeowners Loan Act.

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Furthermore, we believe this can be accomplished without any subjective risk underwriting of individual thrift institutions.

Very truly yours,

Roger C. Wade
Vice President

RCW:jc

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FRANK B. HALL & CO.

Frank B. Hall & Co. is among the world's largest, most prominent insurance services organizations. We have gained a reputation as the creative force in our industry by bringing our clients insurance and related financial services to meet their ever-growing risk management needs in a business arena which gets more competitive every day.

We provide insurance placement in the areas of property/casualty, employee benefits, marine, aviation, and reinsurance—all on an international basis. Hall is also highly regarded for its capabilities in self-insurance administration, claims and environmental risk management, excess and surplus lines, captive company management, employee benefits consulting and other related services.

Perhaps we are best known for our ability to design some of the most advanced insurance and risk management programs in operation today, using 21st century strategies and products, many of which we ourselves invented to satisfy the needs of our clients.

Hall operates in 50 countries and employs 7,000 of the world's most talented insurance professionals. As a company, we are more than 120 years old, but our people approach each new risk management opportunity with a youthful zest, as a challenge to their creativity. The result is a company with depth of professionalism in an essential industry, looking forward to an exciting future.

The Protection Connection™

FRANK B. HALL & CO. INC. 1984

Operating and Investor Information

Clients
The Company's clients include a broad range of commercial and industrial enterprises engaged in transportation, maritime, manufacturing, marketing, finance and other businesses.

Competition
The insurance brokerage and services business is highly competitive. Many brokerage and agency concerns as well as individual brokers and agents throughout the world actively compete with Frank B. Hall. Competition in our business is based primarily on the cost of insurance obtained and the quality of services rendered.

Regulation
The insurance business is regulated on the state level in the U.S. and according to the laws of each foreign country in which we operate. In most states and many countries the Company or certain individual employees must be licensed or receive regulatory approval to do business. The Company's operations depend on its continued good standing under these licenses and approvals.

Trading Information
Class: Common Stock, $.50 par value
Exchange: New York Stock Exchange
Symbol: FBH
Price as of March 1, 1985: $26.75 per share
Shares outstanding as of March 1, 1985: 12,894,832
Number of Record Holders as of March 1, 1985: 2,166

Annual Meeting
The Annual Meeting of Stockholders of Frank B. Hall & Co. Inc. will be held at the Company's World Headquarters, 549 Pleasantville Road, Briarcliff Manor, New York 10510 on Tuesday, May 14, 1985 at 10 a.m. New York City time.

Form 10-K
Any Stockholder wishing to obtain a copy of the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission may do so without charge by writing to the Secretary, Frank B. Hall & Co. Inc., 549 Pleasantville Road, Briarcliff Manor, New York 10510.

Registrar
The Bank of New York, N.A.

Auditors
Touche Ross & Co.

Transfer Agent
The Bank of New York, N.A.

World Headquarters
Frank B. Hall & Co. Inc.
549 Pleasantville Road
Briarcliff Manor, New York 10510
Telephone (914) 769-9200 • Telex 996505
Answerback HALLCOY BRFF

New York City Corporate Office
261 Madison Avenue
New York, New York 10016
Telephone (212) 922-1300 • Telex 12399

Business
The Company and its subsidiaries are engaged throughout the world in a general insurance brokerage business as well as in related risk management and financial services.

Types of Service
Insurance Brokerage
- Casualty and Property
- Employee Benefits and Life
- Reinsurance • Marine • Aviation

Risk Management and Related Financial Services
Brokerage Specialties
Employee Benefit Administration and Consulting
International Services • Claims Adjusting
Self-Insurance Services • Claims Services
Truck Leasing and Rental
Data Processing Services
Executive Search Services

Corporate Growth
In December 1969 Frank B. Hall became a public company. Since that time we have acquired 87 brokerage and agency businesses, 4 claims adjusting companies, a one-way truck rental company, a computer services company, an employee benefits administration and consulting company and an executive recruiting company.

Facilities
Domestic: 202 • Overseas: 88 • Total Locations: 290

Personnel
Domestic: 5,000 • Overseas: 2,000
Total Employees: 7,000

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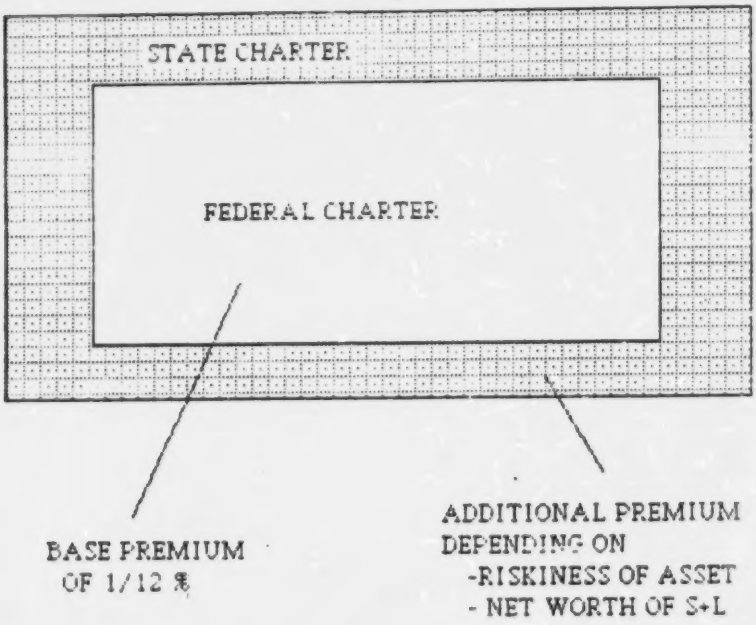
FSLIC PREMIUM CHARGES BY TYPE OF ASSET



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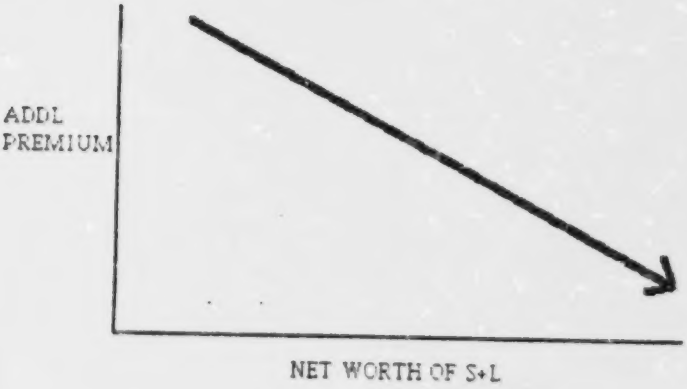

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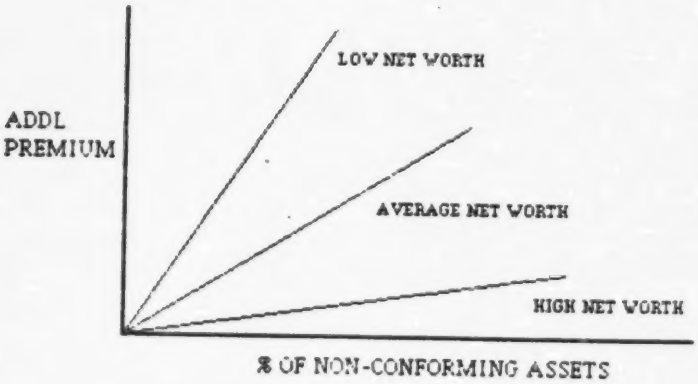

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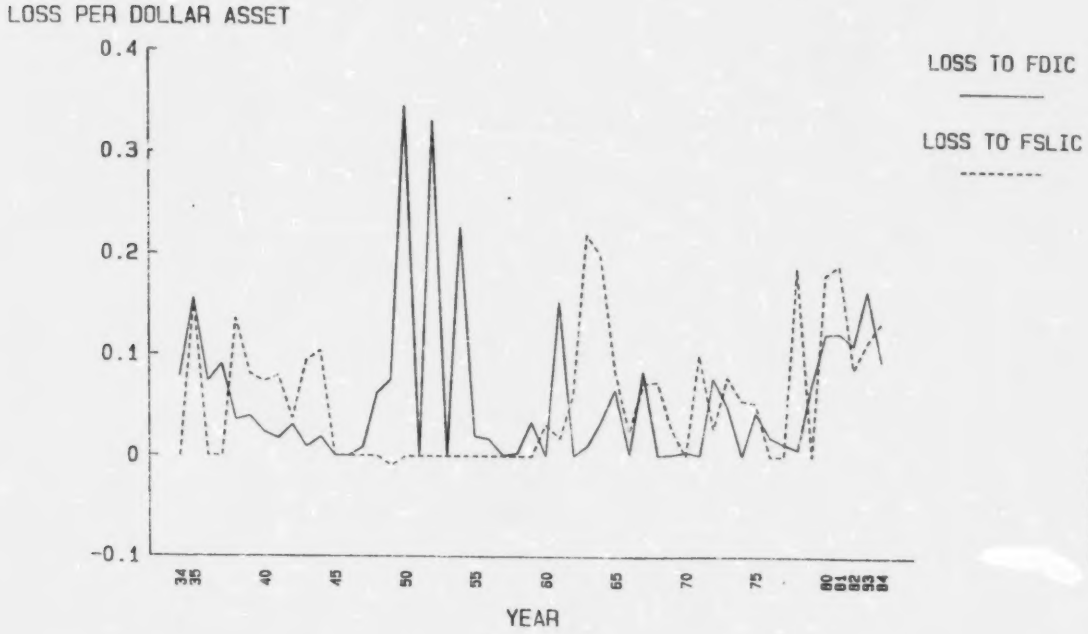
AVERAGE LOSSES TO THE FSLIC AND THE FDIC PER DOLLAR ASSETS OF FAILED INSTITUTIONS



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APPENDIX C

Federal Home Loan Bank Board

Office of the Chairman

APR 12 1984

To: All Supervisory Agents, OES Assistant Directors and District Directors

Subject: Supervisory Actions

The administration of proper, timely and forceful supervisory actions in problem cases is of utmost importance to this Board. In that light, we want to reaffirm and stress some of our standard operating procedures regarding supervisory actions and to require some additional procedures aimed at ensuring that full supervisory responsibilities are met. In light of problems that have occurred, implementation of these procedures is of utmost urgency and should begin immediately.

1. When examination reports -- final or interim -- reveal substantial problems of any type, the Supervisory Agent will immediately meet with the institution's board of directors and: (1) discuss the problems; (2) require expeditious corrective action and; (3) obtain a formal supervisory agreement in order to obtain such corrective action.

2. The Supervisory Agents are directed to review all exam reports completed within the last 12 months for comments which disclose disarray in the institution's books and records to such an extent that they do not provide an accurate and complete record of all business transactions. Such failure to maintain records is a violation of the insurance regulations and is an unsafe and unsound practice. If an institution has not promptly taken appropriate corrective action after the Supervisory Agent has requested corrective action as described in (1) above, the Supervisory Agent is to immediately refer the case to the Enforcement Division of OGC, through the OES Assistant Director, for the initiation of a cease and desist proceeding. Similarly, if future examination reports disclose failures to maintain adequate books and records, as described above, the Supervisory Agents are directed to follow the same procedures.

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3. The OES District Directors are directed to obtain immediate on-site evaluation of institutions that exhibit excessive growth or significant behavioral deviations from past performance.

4. The Supervisory Agents are directed to require submission of business plans by the proposed applicants in connection with all change of control filings. The District Directors of OES are directed to examine institutions within six months after the change in control and to determine that the institution is operating pursuant to the business plan.

5. The OES Assistant Directors-Regional Operations are responsible for monitoring the results of examinations and the resulting supervisory actions to ensure that uniform, effective and appropriate supervisory actions are taken. If the supervisory actions are not appropriate, the Assistant Directors will take immediate, forceful corrective action.

Edwin J. Gray
Chairman

Donald I. Hovde
Board Member

Mary A. Grigsby
Board Member

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APPENDIX D

FEDERAL HOME LOAN BANK BOARD

Resolution No. 82-381

Dated: May 26, 1982

WHEREAS, the Federal Home Loan Bank Board has considered the recommendation of the Office of Examinations and Supervision and the Office of General Counsel to adopt a formal statement of policy regarding the Bank Board's use of supervisory actions, and

WHEREAS, the adoption of such statement of policy also will implement a recommendation of the General Accounting Office for the strengthening of the Bank Board's formal supervisory process,

IT IS RESOLVED that the following statement of policy is hereby approved and adopted:

FEDERAL HOME LOAN BANK BOARD STATEMENT OF POLICY REGARDING SUPERVISORY ACTIONS

In carrying out its supervisory responsibilities with respect to thrift institutions insured by the Federal Savings and Loan Insurance Corporation ("FSLIC"), their holding companies, service corporations, and affiliated officers and directors, it is the policy of the Federal Home Loan Bank Board that violations of law or regulation, and unsafe or unsound practices will not be tolerated and will result in the initiation of strong supervisory and/or enforcement action by the Board. It is the Bank Board's goal to minimize, and where possible, to prevent losses occasioned by violations or unsafe and unsound practices by taking prompt and effective supervisory action. Supervisory agents and examiners should promptly identify and take action to prevent the continuation of violations or practices that may result in financial harm to the institution, its customers, or the FSLIC before such harm actually has resulted.

The Board recognizes that supervisory actions must be tailored to each case, and that such actions will vary according to the severity of the violation of law or regulation or the unsafe or unsound practice, as well as to the responsiveness and willingness of the association to take corrective action. The following guidance should be considered for all supervisory actions.

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In each case, based upon an assessment of management's willingness to take appropriate corrective action and the potential harm to the institution if corrective action is not effected, the staff must weigh the appropriateness of available supervisory actions. If the potential harm is slight and there is a substantial probability that management will correct the situation, informal supervisory guidance and oversight is appropriate. If some potential harm to the institution or its customers is likely, a supervisory agreement should be promptly negotiated and implemented. If substantial financial harm may occur to the institution, its customers, or the FSLIC and there is substantial doubt that corrections will be made promptly, a cease-and-desist order should be sought immediately through the Office of the General Counsel.

In those instances where substantial harm to the association, its customers, or the FSLIC is not likely, but there are continuing violations of law or regulations or of unsafe or unsound practices, and informal supervisory actions, including the implementation of supervisory agreements, have not resulted in prompt satisfactory corrective action, or in those instances where there are subsequent or repeated violations after informal supervisory actions have been taken, cease-and-desist actions should be pursued through the Office of General Counsel.

To expedite the implementation of appropriate cease-and-desist actions, the Bank Board, on February 18, 1982 (Resolution No. 82-99), delegated to the staff the authority to negotiate consent cease-and-desist orders, subject to final Bank Board approval.

By the Federal Home Loan Bank Board

J. J. Finn
Secretary

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BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Examination Of The Federal Savings And Loan Insurance Corporation's Financial Statements For The Years Ended December 31, 1984 and 1983

GAO examined the financial statements of the Federal Savings and Loan Insurance Corporation for the years ended December 31, 1984 and 1983. The examinations were made in accordance with generally accepted government auditing standards.

As of December 31, 1984, the Corporation held $1.8 billion in subrogated accounts and secured advances (claims against the assets of closed institutions). Empire, Knox Federal, and San Marino savings and loan associations account for $1.3 billion of these claims. The net amount that will be realized from the claims against these three institutions is uncertain. The Corporation has established a $468 million allowance for loss for the assets acquired from these three institutions. However, the recency of the San Marino and Knox failures, along with inadequate loan records and pending and possible litigation affecting the three institutions, precludes finalizing the estimated net realizable value of the assets.

In GAO's opinion, subject to the uncertain net realizable value of the assets acquired from Empire, Knox Federal, and San Marino, the financial statements present fairly the financial position of the Corporation as of December 31, 1984 and 1983, the results of its operations and the changes in its financial position for the years then ended, in conformity with generally accepted accounting principles.

Because of the many imponderables involved in forecasting the sufficiency of the insurance fund to meet future claims against it, our opinion on the financial statements does not extend to the adequacy of the fund.

GAO/AFMD-85-60
JULY 16, 1985

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-114893

To the President of the Senate and the
Speaker of the House of Representatives

This report presents our opinion on the Federal Savings and Loan Insurance Corporation's financial statements for the years ended December 31, 1984 and 1983. We believe the statements are fairly presented subject to the uncertain net realizable value of $1.3 billion of assets on the 1984 statements that the Corporation acquired from the failure of three insured savings and loan associations. The Corporation incurred a loss of $879 million in 1984, resulting from protecting depositors and assisting problem institutions, and could sustain future losses in subsequent accounting periods. Because of the many imponderables involved in forecasting the sufficiency of the insurance fund to meet future claims against it, our opinion on the financial statements does not extend to the adequacy of the fund. Appendix I is our report on the Corporation's system of internal accounting controls, and appendix II is our report on the Corporation's compliance with laws and regulations.

The Federal Savings and Loan Insurance Corporation is a wholly owned government corporation that is governed by the Federal Home Loan Bank Board. The Corporation is responsible for insuring the safety of savings in thrift and home financing institutions. The Comptroller General is required to audit the financial transactions of wholly owned government corporations under 31 U.S.C. 9105. We conducted our examinations in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Director of the Office of Management and Budget, the Secretary of the Treasury, and the Chairman of the Federal Home Loan Bank Board.

Charles A. Bowsher

Comptroller General
of the United States

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

May 10, 1985

B-114893

The Honorable Edwin J. Gray
Chairman, Federal Home Loan
Bank Board

Dear Mr. Gray:

We have examined the statements of financial position of the Federal Savings and Loan Insurance Corporation as of December 31, 1984 and 1983, and the related statements of income and expense and reserves, and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted government auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As of December 31, 1984, the Corporation, in its role as liquidator of failed institutions, held $1.8 billion in subrogated accounts and secured advances (claims against the assets of closed institutions). Empire Savings and Loan, Knox Federal Savings and Loan, and San Marino Savings and Loan account for $1.3 billion of these claims. The estimated net realizable value of these claims is uncertain. Although the Corporation has established a $468 million allowance for loss for the assets acquired from the three institutions, the recency of the San Marino and Knox failures, inadequate loan records, and pending and possible litigation affecting the three institutions preclude finalizing the estimated net realizable value of the assets acquired.

In our opinion, subject to the uncertain value of the $1.3 billion of assets on the 1984 statements that the Corporation acquired from the three failed insured savings and loan institutions, the financial statements referred to above present fairly the financial position of the Federal Savings and Loan Insurance Corporation as of December 31, 1984 and 1983, and the results of its operations and changes in financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

- - - - -

In 1984, the Corporation incurred a loss of $879 million resulting from protecting depositors and assisting problem institutions, and could sustain future losses in subsequent periods. The

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savings and loan industry has been thinly capitalized and confronted by narrow interest rate margins and poor quality loans and investments. As of December 31, 1984, the Corporation had reserves of about $5.6 billion, and as discussed in note 11 to the financial statements, as of March 31, 1985, the Corporation had obtained a special assessment totaling $245 million from all federally insured institutions to strengthen the insurance fund. Because of the many imponderables involved in forecasting the sufficiency of the insurance fund to meet future claims against it, our opinion on the financial statements does not extend to the adequacy of the fund.

Sincerely yours,

Charles A. Bowsher

Comptroller General
of the United States

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APPENDIX I

REPORT ON INTERNAL ACCOUNTING CONTROLS

We have examined the financial statements of the Federal Savings and Loan Insurance Corporation for the years ended December 31, 1984 and 1983, and have issued our opinion thereon. As part of our examinations, we made a study and evaluation of the system of internal accounting controls to the extent we considered necessary to evaluate the system as required by generally accepted government auditing standards. This report pertains only to our study and evaluation of internal accounting controls for the year ended December 31, 1984. (Our report on the system of internal accounting controls for the year ended December 31, 1983 is presented in GAO/AFMD-84-47, 5/30/84.) For the purpose of this report, we have classified the significant internal accounting controls in the following categories:

--assistance to problem savings and loan associations,

--expenditures,

--financial reporting,

--insurance premiums, and

--investments.

Our study included all of the control categories listed above. However, we did not evaluate the accounting controls over assistance to problem savings and loan associations, financial reporting, and investments because it was more efficient to expand substantive audit tests. The purpose of our study and evaluation was to determine the nature, timing, and extent of the auditing procedures necessary for expressing an opinion on the Corporation's financial statements. Our study and evaluation was more limited than would be necessary to express an opinion on the system of internal accounting controls taken as a whole or on any of the categories of controls identified above.

The management of the Federal Savings and Loan Insurance Corporation is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of the inherent limitations in any system of internal control, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

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APPENDIX I

APPENDIX I

Our study and evaluation was made for the limited purpose described in the first paragraph and would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the system of internal accounting controls of the Federal Savings and Loan Insurance Corporation taken as a whole or on any of the categories of controls identified in the first paragraph. However, our study and evaluation disclosed no condition that we believed to be a material weakness.

APPENDIX II

APPENDIX II

REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

We have examined the financial statements of the Federal Savings and Loan Insurance Corporation for the years ended December 31, 1984 and 1983, and have issued our opinion thereon. Our examinations were made in accordance with generally accepted government auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures, including tests of compliance with laws and regulations, as we considered necessary in the circumstances. This report pertains only to our review of compliance with laws and regulations for the year ended December 31, 1984. (Our report on compliance with laws and regulations for the year ended December 31, 1983, is presented in GAO/AFMD-84-47, 5/30/84.)

In our opinion, the Corporation complied with the terms and provisions of laws and regulations for the transactions tested that could have materially affected the financial statements.

Nothing came to our attention in connection with our examination that caused us to believe that the Corporation was not in compliance with the terms and provisions of applicable laws and regulations for those transactions not tested.

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APPENDIX III

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
COMPARATIVE STATEMENT OF CONDITION
DECEMBER 31, 1984 AND 1983

	1984	1983
Assets		
Cash	$ 2,764,236	$ 1,160,313
Insurance Premiums and Accounts Receivable	37,803,382	46,336,719
Investments (Note 2)	5,869,307,301	6,799,195,381
Interest Receivable on Investments	58,296,395	70,840,669
Loans to Insured Institutions (Note 7)	92[illegible],349,947	208,749,278
Interest Receivable on Loans to Insured Institutions	4,157,244	3,433,918
Subrogated Accounts in Insured Institutions	1,156,502,895	351,876,053
Less: Allowance for Possible Future Losses	642,597,193	108,800,000
Net Subrogated Accounts (Note 3)	513,905,702	243,076,053
Income Capital and Net Worth Certificates	865,163,795	850,100,000
Dividends Receivable on Net Worth Certificates	526,598	260,572
Less: Allowance for Possible Future Losses	146,857,000	101,500,000
Net Income Capital and Net Worth Certificates (Note 5)	718,833,393	748,860,572
Secured Advances Due from Receiver	642,809,038	-0-
Less: Allowance for Possible Future Losses	60,127,729	-0-
Net Secured Advances Due from Receiver (Note 8)	582,681,309	-0-
Mortgage Loans and Real Estate	297,246,914	253,277,765
Less: Allowance for Possible Future Losses	69,758,005	27,638,989
Net Mortgage Loans and Real Estate	227,488,909	225,638,776
Total Assets	8,937,587,818	8,347,291,679
Liabilities and Reserves		
Accounts Payable and Other Liabilities	55,670,776	33,358,958
Notes Payable to FHLBanks (Note 7)	700,000,000	-0-
Notes Payable to Insured Institutions (Note 6)	834,834,936	842,603,148
Accrued Interest on Notes Payable	35,044,537	38,335,993
Allowance for Possible Future Losses Under Contribution Agreements (Note 4)	1,706,261,101	1,007,582,054
Primary Reserve (Note 9)	4,885,037,594	5,764,250,686
Secondary Reserve (Note 9)	720,729,874	661,160,838
Total Liabilities and Reserves	$ 8,937,587,818	$ 8,347,291,679

The accompanying notes are an integral part of these financial statements.

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FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
COMPARATIVE STATEMENT OF INCOME AND EXPENSE AND RESERVES
FOR THE YEARS ENDED DECEMBER 31, 1984 AND 1983

	1984	1983
Income		
Insurance Premiums (Note 1)	$ 596,940,890	$ 508,491,095
Interest on Investments	655,265,644	604,655,968
Interest on Loans to Insured Institutions	42,396,735	20,200,094
Income on Mortage Loans and Real Estate	18,412,484	28,194,774
Other Income	11,962,043	931,950
Total Income	1,324,977,796	1,162,472,981
Expenses		
Administrative Expenses	1,233,731	1,076,727
Net Loss on Sale of Securities	-0-	17,887,091
Services Rendered by The Federal Home Loan Bank Board (Note 8)	28,365,685	30,276,417
Interest on Notes Payable to FHLBanks	23,785,879	-0-
Interest on Notes Payable to Insured Institutions	89,458,494	66,662,590
Insurance Settlement and Other Expenses	21,666,975	16,928,393
Provision for Possible Future Losses on:		
Contribution Agreements (Note 4)	1,293,503,676	895,178,263
Mortgage Loans and Real Estate	62,771,576	5,000,000
Income Capital and Net Worth Certificates	45,357,000	(68,400,000)
Subrogated Accounts (Note 3)	516,764,330	103,038,249
Secured Advances Due from Receiver	60,127,729	-0-
Total Expenses	2,143,035,075	1,067,547,730
Net Income (Loss) From Operations	(818,057,279)	94,925,251
Interest Applied to the Secondary Reserve (Note 9)	61,165,813	47,758,026
Net Income (Loss)	(879,223,092)	47,067,225
Reserves at Beginning of Year	6,425,421,524	6,330,843,117
Increase to Secondary Reserve	59,569,036	47,511,182
Reserves at End of Year (Note 9)	$ 5,605,767,468	$ 6,425,421,524

The accompanying notes are an integral part of these financial statements.

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APPENDIX III

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
STATEMENT OF CHANGES IN FINANCIAL POSITION
FOR THE YEARS ENDED DECEMBER 31, 1984 AND 1983

Source of Funds:	1984	1983
Net Income (Loss)	$ (879,223,092)	$ 47,067,225
Add (deduct) Items not Requiring, or Generating Cash:		
Depreciation of F&E	27,019	16,559
Provision for Possible Future Losses on:		
Mortgage Loans and Real Estate	62,771,576	5,000,000
Income Capital and Net Worth Certificates	45,357,000	(68,400,000)
Contribution Agreements	1,293,503,676	895,179,263
Subrogated Accounts	533,797,193	108,800,000
Secured Advances Due from Receiver	60,127,729	-0-
Return on Secondary Reserve	61,165,813	47,758,026
Transfer from Secondary Reserve	(1,438,798)	(189,802)
Accretion and Amortization on Investments	(26,341,231)	(96,597,810)
Funds Provided from Operations	1,149,746,885	938,632,461
Increase (Decrease) in:		
Notes Payable - to FHLBanks	700,000,000	-0-
Accounts Payable and Other Liabilities	22,320,818	7,977,931
Decrease (Increase) in:		
Investments and Interest Receivable	967,451,610	(313,971,377)
Accounts and Dividends Receivable	8,267,311	(23,655,860)
Total	2,847,786,624	608,983,135
Application of Funds:		
Increase (Decrease) in:		
Subrogated Accounts	804,626,842	253,427,622
Income Capital & Net Worth Certificates	15,063,795	408,300,000
Amount Paid Under Contribution Agreements	524,824,629	592,954,336
Refund of Secondary Reserve	157,979	57,042
Secured Advances Due from Receiver	642,809,038	-0-
Loans to Insured Institutions and Interest Receivable	714,323,995	(134,239,374)
Mortgage Loans and Real Estate	63,326,753	(105,807,758)
Decrease (Increase) in Notes Payable and Accrued Interest	11,049,670	(406,666,414)
Total	2,846,182,701	608,025,454
Increase in Cash	$ 1,603,923	$ 957,681

The accompanying notes are an integral part of these financial statements.

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APPENDIX III

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 1984 AND 1983

1. Summary of Significant Accounting Policies:

   a) Income Recognition - Insurance Premium Income is recognized as earned when member institutions are assessed.

   b) Generally the Provision for Possible Future Losses is recorded when a default prevention action is taken.

2. Investments - Investment securities are stated at cost, adjusted for amortization of premiums and accretion of discounts. Such amortization and accretion are computed on the level yield method at rates based upon the lives of the related securities. Both amortization and accretions are recognized as an adjustment to Interest on Investments.

   All cash received by the Corporation which is not used to defray operating expenses or for outlays related to assistance to insured institutions and liquidation activities, is invested in U.S. Treasury securities. Other obligations are mostly securities issued by Federal Government Agencies other than the U.S. Treasury which were obtained through the Corporation's default prevention activities. As of December 31, 1984 and 1983, the Corporation's investment portfolio consisted of the following:

	1984		1983	
	Book Value	Market Value	Book Value	Market Value
	(In thousands)		(In thousands)	
U.S. Treasury Obligations:				
Overnight Funds	$ 2,334,219	$ 2,334,219	$ 1,946,558	$ 1,946,558
Maturities up to One Year	542,497	545,407	1,488,841	1,484,025
Maturities Over One Year	2,164,708	1,881,044	2,491,754	2,118,038
Subtotal:	5,041,424	4,760,670	5,927,153	5,548,621
Other Obligations:				
Maturities Up to One Year	125	119	-0-	-0-
Maturities Over One Year	827,758	756,045	872,042	802,804
Subtotal:	827,883	756,164	872,042	802,804
Total:	$ 5,869,307	$ 5,516,834	$ 6,799,195	$ 6,351,425

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3. Subrogated Accounts - As required by Statute, the FSLIC closes institutions only when there is no default prevention measure that would be less costly than liquidation. In these cases, FSLIC settles insurance claims either by cash payout of insured accounts or by transferring insured accounts to another insured institution. In either case insurance payment is made in exchange for the account holder's claim against the assets of the defaulted institution. Subrogated Accounts represent the total of these outstanding claims. The changes in the Allowance for Possible Future Losses on Subrogated Accounts for the years ended December 31, 1984 and 1983 are:

	1984	1983
	(in thousands)	
Balance, Beginning of Year	$ 108,800	$ -0-
Add: Net Provision Charged to Expense	516,764	103,038
Net Premiums	17,033	5,762
Balance, End of Year	$ 642,597	$ 108,800

4. Contribution Agreements - The FSLIC makes contribution agreements to prevent default of an insured institution. Under some of these agreements the Corporation agrees to make, or commits itself to make, certain contributions over time. The FSLIC may incur additional contingent liabilities in excess of Possible Future Losses resulting from uncertainties concerning litigation and other undisclosed liabilities. However, it is management's opinion that these amounts cannot be reasonably estimated. The changes in the Allowance for Possible Future Losses Under Contribution Agreements for the years ended December 31, 1984 and 1983 are:

	1984	1983
	(in thousands)	
Balance, Beginning of Year	$ 1,007,582	$ 705,358
Add: Provision Charged to Expense	1,293,504	895,178
Less: Contributions Paid	594,825	592,954
Balance, End of Year	$ 1,706,261	$ 1,007,582

5. Income Capital & Net Worth Certificates - Since 1981 the FSLIC has purchased Income Capital Certificates (ICC's) from insured institutions. The FSLIC records the ICC's at cost. The ICC's earn annual income payments based on the United States Treasury Bill rates. The annual income payments and principal are redeemable upon the issuing institution having profitable operations and attaining a specified net worth level. The changes in the ICC's for the years ended December 31, 1984 and 1983 are:

	1984	1983
	(in thousands)	
Balance, Beginning of year	$ 773,200	$ 404,300
Add: Net Purchases (Decrease) During Year	(52,586)	368,900
	720,614	773,200
Less: Allowance for Possible Future Losses (Cumulative)	142,857	92,750
Balance, End of Year	$ 577,757	$ 680,450

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APPENDIX III

5. (Con't)

In addition, since 1982 the FSLIC has purchased Net Worth Certificates (NWC's) from insured institutions as part of its default prevention activities. NWC's earn annual income payments based on the cost of Federal Home Loan Bank System Obligations plus 1/4 of one percent. Annual income and principal payments are redeemable upon the issuing institution having profitable operations and attaining a specified net worth level. Such payments have been accrued for institutions meeting these requirements. The changes in the NWC's for the years ended December 31, 1984 and 1983 are:

	1984	1983
	(in thousands)	
Balance, Beginning of Year	$ 76,900	$ 37,500
Add: Purchases During Year	67,650	39,400
	144,550	76,900
Add: Dividends Receivable	526	261
Less: Allowance for Possible Future Losses (Cumulative)	4,000	8,750
Balance, End of Year	$141,076	$ 68,411

6. Notes Payable to Insured Institutions - The FSLIC has outstanding negotiable notes to purchase ICC's and promissory notes to purchase ICC's and NWC's in the amount of $536,450,000 as of December 31, 1984, and $776,900,000 as of December 31, 1983. Variable interest is paid semiannually based on the cost of Federal Home Loan Bank System Obligations or the average auction yield for United States Treasury Notes with maturities from 5-10 years. In addition to issuing notes to purchase ICC's and NWC's, the FSLIC has also issued other negotiable notes to carry out it default prevention activities in the amount of $298,384,936 as of December 31, 1984, and $65,703,148 as of December 31, 1983.

7. Loans to Insured Institutions - The FSLIC has made loans to insured institutions on occasion as part of its default prevention activities. The outstanding balance of these loans at December 31, 1984 and 1983 were $922,349,947 and $208,749,278, respectively. The majority of the increase was a $700,000,000 collateralized loan to an insured institution.

In order to finance the loan to an insured institution, FSLIC issued a $700,000,000 collateralized note to a FHLBank. Interest on the note is based on the cost of funds of the FHLBank plus twenty basis points. Interest on the loan is based on the monthly weighted average cost of funds charged to members of the FHLBank in which the insured institution is located.

8. Related Party Transactions - The Federal Home Loan Bank Board is an independent Federal agency in the executive branch of government and governs the Federal Savings and Loan Insurance Corporation (FSLIC). The Bank Board assessed the FSLIC for services rendered in the amount of $28,365,685 for 1984 and $30,276,417 for 1983. The principal function of the FSLIC is to insure accounts in savings and loan associations and federal mutual savings banks.

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8. (Con't)

In addition, the FSLIC, as part of its default prevention activities, may guarantee repayment of FHLBank advances that were made to certain insured institutions. These guarantees are typically granted on a short-term basis, generally covering advances that are secured. The amount of these advances as of December 31, 1984, totaled $1,715 million and $559 million at December 31, 1983. In the event that it is called upon to honor these guarantees, the FSLIC has claim against any assets pledged as collateral to secure such advances. The FSLIC honored $642,809,038 of guaranteed advances during 1984 and exercised its claim to the assets securing these advances. An allowence for possible future losses in the amount of $60,127,729 was also established.

9. Reserves - The FSLIC's total reserves available for losses consist of the Primary and Secondary Reserves. The Secondary Reserve is the equity of certain institutions in FSLIC based on premium prepayments and related interest not yet paid to these institutions. It is available for losses, but may also be paid back to the institutions depending on FSLIC's financial condition and management's anticipation of losses. Interest of $61,165,813 was credited to the Secondary Reserve based on the yield of FSLIC's investment portfolio. The Primary Reserve is the cumulative net income of the FSLIC since its inception less the interest applied to the Secondary Reserve.

	1984	1983
Primary Reserve		
Balance, Beginning of Year	$ 5,764,260,686	$ 5,693,669,737
Prior Period Adjustments	-0-	23,523,724
As Restated	5,764,260,686	5,717,193,461
Net Income (Loss)	(879,223,092)	47,067,225
Balance, End of Year	4,885,037,594	5,764,260,686
Secondary Reserve		
Balance, Beginning of Year	661,160,838	613,649,656
Interest Applied	61,165,813	47,758,026
Transfers and Refunds	(1,596,777)	(246,844)
Balance, End of Year	720,729,874	661,160,838
Total Reserves at End of Year	$ 5,605,767,468	$ 6,425,421,524

10. Retirement Plan - All permanent, full-time and part-time employees who were employed by the FSLIC prior to January 1, 1984, are covered by the contributory Civil Service Retirement Plan. The Corporation makes bi-weekly contributions to the plan equal to the employee's bi-weekly contributions. Employees hired after January 1, 1984 fall under the Social Security Act; however, they also contribute 1.3% and the Corporation 7% to the Civil Service Retirement Plan. The retirement plan expense incurred for calendar years 1984 and 1983 were $258,366 and $241,567 respectively.

11. Given the state of the economy and present condition of the industry, it is possible that FSLIC could sustain additional losses in subsequent accounting periods due to its default prevention actions. Because many of the causes for default are beyond managment's control, the amount of these losses cannot be determined. However, the Corporation believes that its resources, including the right to increase insurance premiums, are sufficient to absorb any such losses over the foreseeable future.

The Federal Home Loan Bank Board, as the operating head of FSLIC, on February 22, 1985, authorized FSLIC to assess each insured institution an additional premium for insurance in an amount equal to one-thirty second of one per centum of the total amount of the accounts of the members of each insured institution determined as of December 31, 1984. The additional $245 million insurance premium assessed was paid by each insured institution on or about March 31, 1985. The Bank Board also expressed its intention to consider the assessment of further additional premiums in amounts equal to one thirty second of one per centum on a quarterly basis during 1985. If adopted, such assessments would increase income by an additional $750 million.

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The CHAIRMAN. Mr. Gray, on Tuesday, we had some witnesses who were very forceful in their opposition to risk-related premiums. I questioned at considerable length their preconceived ideas and their unwillingness to even consider risk-related premiums. Their major objections are what you have already referred to as complexity. But even more importantly, I suppose their objection was that it would create runs. This information would obviously get out, and the institutions would be classified and customers would find out that they were paying a higher premium.

How do you respond to that criticism?

Mr. GRAY. Well, I think they're talking about an entirely different approach to a variable risk premium. If an institution were rated in the way that some proposals have suggested, then I think that is quite possible and that is precisely why I and the members of the Bank Board were concerned about going down that path where you rate an institution and you're most likely to rate the institution based on the behavior of the past retrospectively.

FEASIBLE APPROACH TO RISK PREMIUMS

What we tried to design was an entirely different kind of risk premium which assumed that the Congress determined what it found suitable for our group insurance plan in the Garn-St Germain Act and the authorities it provided, and to establish a scheme by which there would be outside of that circle, if you will, a series of groupings of activities themselves which could be priced for risk. And we consulted very closely with, as I suggested, a major international insurance brokerage and consulting firm, to determine the feasibility from their point of view, and they said this was a feasible approach.

As I suggested, there are certain arbitrary aspects to this in that you are arbitrarily grouping certain kinds of activities and pricing them for risk, but in this way you do not rate the institution. There is nothing that is going to cause any institution a problem. In fact, I think that if we were to rate that institution and try to price the risk based on the condition of the institution, the institutions least able to pay would have to pay the highest premium and those institutions which had the best condition would be in the best position to pay and in this way I think we might well hasten the demise of the institution itself, just as a result of the premiums themselves.

But in our case we are talking about activities. And in my view, to the extent an institution wants to engage in activities which are deemed riskier, pay the pricing involved—to the extent an institution wants to do it and to the extent it has the net worth which would cushion against the risk of loss to the FSLIC and also which at the same time would actually lower the cost of the premium, the higher the net worth of the institution, such a system therefore would provide an incentive for institutions to increase their net worth, and this would not cause that problem.

That is a long way to answer a short question.

The CHAIRMAN. Well, I would assume that critics, however, would still say that although you're doing it by categories, if it's recognized in the marketplace that they have a higher percentage

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of their assets in a more risky grouping and therefore paying higher premiums, you're still going to end up with the same result. You're going to have people withdrawing.

Mr. GRAY. I would not agree with that, No. 1. Second, in my view—and I want to get back to this again—there is the most unfair, most arbitrary allocation of the cost of risk to our institutions right now. Unless we can get at that problem, it seems to me we are not going to inspire the confidence of our institutions to move forward to try to deal with the longer term problems of replenishing the funds of the FSLIC and making a commitment to do that.

The CHAIRMAN. Do you feel that paying higher premiums through your method or others would cause managers, CEO's, loan officers to make more prudent decisions in the type of activities they're going into or the judgment of risk on the loans that they are making?

Mr. GRAY. I do, because obviously they would have to know in advance for determining their own strategy what kind of pricing they would have to pay and if they could only get into that kind of activity if they were willing to pay that price, I think that in itself would inject a very healthy measure of self-discipline into the institution and, for that matter, the industry as a whole.

The CHAIRMAN. What is your view of the use of current value accounting for regulatory purposes?

Mr. GRAY. I think that at the moment since regulatory accounting is really a reporting tool for us to use in determining how we deal with FSLIC problems, that we have the tools that we need already. This is not to say, incidentally, that I do not believe—to answer it in another way—that the Bank Board should not move in a deliberate way over time to try to bring regulatory accounting and generally accepted accounting principles into closer conformity over time, and we have been studying for several months now a means by which an orderly appropriate phase-in could occur over a long period of time.

The CHAIRMAN. What are your views with respect to a State granting an out of State bank holding company a commercial bank charter if it will assume all or part of deposit liabilities of a State-chartered thrift institution?

Mr. GRAY. You say a bank——

The CHAIRMAN. I'm saying an out of State bank holding company that is, if a State says, OK, if you come in and take over this thrift that we're having problems with, either all or part of it, we will give you a bank charter.

WELCOME ACQUIRERS OF TROUBLED THRIFTS

Mr. GRAY. We would welcome that. As a matter of fact, there have been some notions that have been spread around that somehow the Bank Board has a policy which discriminates against banks taking or seeking to acquire FSLIC-insured thrifts—that is, thrifts in the FSLIC category. There is absolutely no truth to that. The notion is false. I want to put it to bed. We are looking for acquirers, insurance companies, industrial companies, commercial banks, as long as they are willing to play by our rules and willing

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to help us solve some of the assistance costs to the FSLIC, we would welcome them into our industry.

The CHAIRMAN. In Ohio as the FSLIC, are you personally involved in trying to foster local solutions?

Mr. GRAY. What kind of local solutions?

The CHAIRMAN. In the Ohio situation, were you or the FSLIC personally approached to try and come up with local solutions in Ohio?

Mr. GRAY. You mean for the ODGF member institutions?

The CHAIRMAN. Yes.

Mr. GRAY. I'll try to answer it this way.

The CHAIRMAN. I'm particularly thinking of the Home State situation.

Mr. GRAY. Well, in that case, the State said that it was going to provide a certain amount of assistance. There were requests for bids from the State. A bank submitted its bid and I guess at about the 11th hour another thrift in Ohio came in and presented its bid. It happened to be better, and for that reason the Bank Board determined on the recommendation of the principal supervisory agent after having the information we needed that the thrift would qualify.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Chairman Gray, you have a 16-page statement that says virtually nothing about the overriding problem of the thrift industry--inadequate capital. Let me cite just a few figures from the Bank Board's own staff. In 1980, the net worth of the S&L industry under generally accepted accounting principles was 5.26 percent of the total assets. By the end of 1982, it dropped almost in half, to 2.95 percent. By the end of 1984, it declined still further to a 2.87 percent. That is, the industry as a whole.

The picture is even bleaker for the weakest institutions. At the end of 1982, 37 percent of the industry had a net worth of under 3 percent. By the end of 1984, 45 percent of the industry was under 3 percent. Even more disturbing are insolvencies. At the end of 1982, 7 percent of the industry was insolvent--that is, the institutions had negative net worth as measured by generally accepted accounting principles. By the end of 1984, 10 percent of the industry was insolvent.

So clearly, the problem of capital inadequacy is getting worse, not better, and yet I don't see anything in your program that addresses that issue or even recognizes that it's a problem.

What can you tell us to reassure us?

WAYS TO DEAL WITH NET WORTH PROBLEM

Mr. GRAY. Well, we certainly recognize the problem and, Senator, I think our record would show that we have sought in every way possible to try to deal with it. For example, we have encouraged conversions and we have simplified the procedures by which mutual institutions can convert to stock and therefore raise capital. We also have encouraged the use of subordinated debt where an institution can qualify for subordinated debt, which serves as capital. We have, contrary to some stories which have been out and

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about, encouraged and sought acquisitions by outside acquirers, as I have suggested.

In addition, with the adoption of our net worth regulation early this year, we phased out some of the distortive effects on computing net worth which resulted from 20-year phase-in and 5-year averaging. And we also have required institutions to correlate their growth to net worth, which is in itself a better way to achieve discipline and to say that you grow on certain levels of net worth.

I don't think that any of us have thought that the problem of capital adequacy which has been in this industry for a long time—I remember back in the 1970's it was discussed at great length in the industry—that this is a problem that any of us can ignore and I certainly didn't mean to ignore it by failing to mention it in my statement. In fact, I attempted to point out that we did have that net worth regulation early this year.

This is a problem. As you know, in the fall 1984, the Comptroller of the Currency by regulatory fiat opened the loophole for nonbank banks and very quickly our bidders for FSLIC insured institutions, bidders which would have brought in more capital, dried up. Why would they want to help us in that regard if they could get a nonbank bank charter for a $5,000 or $7,500 application and go out and get interstate franchise rights around the country?

All of these things have combined to not help the situation and we are not wizards at how to solve this long-standing problem of capital adequacy in our industry. But very clearly you have hit upon a point. There has to be an increase in the capital levels of our industry, but we could declare by statement that the required capital levels of our institutions tomorrow would be 4 percent, for example. I'm not sure that would produce any more capital. I don't think it would. It would just place more institutions in a supervisory category.

Senator PROXMIRE. Well, let me zero in on the 10 percent of the industry that is insolvent. According to this same study by the Board's staff, at the end of 1984, there were 434 insolvent savings and loan associations. That is, they had negative net worth. The assets of these insolvent S&L's totaled $107 billion or about 10.4 percent of the entire industry. The Board staff has estimated that on the basis of prior experience, if these insolvent institutions were closed, the cost to FSLIC would be over $15 billion.

As you know, FSLIC has unencumbered reserves of less than $6 billion. So my question to you is twofold. First, why does the Board allow these insolvent institutions to continue operating? Your own staff estimates that when the ultimate day of reckoning occurs the losses will be even greater than if they were closed today. Second, how does the Bank Board propose to make up the deficiencies in the FSLIC fund? As I figure it, you need at least $20 billion and probably $25 billion to pay off unrecognized losses and rebuild reserves. Who's going to provide that $25 billion?

Mr. GRAY. Well, it is an obviously extremely difficult issue. We have to operate on the resources that we have.

As you know, we exercised our authority under law to increase to the maximum the supplementary special premiums which can be assessed on our institutions of up to one-eighth of 1 percent additional per year. We took that action early this year.

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That has produced thus far this year an additional $500 million to the fund's reserves.

But in all candor, when we know what the reserves of the fund are and we also know the limits of our ability to deal with those insolvent cases in a way that has been suggested, we come up against a stone wall. So the Board has been trying as best it has been able to to deal with this problem. We have instituted a program, for example, early this year whereby when an institution becomes insolvent we immediately take it in receivership, create a new mutual if it's a stock institution, and bring in a management team from a well-run savings institution. Our purpose is to halt the losses, to get as accurate a picture as possible of the portfolio of the institution, and during that period to begin to seek acquirers of these institutions.

But obviously, you know we are not magicians and we cannot create FSLIC reserves out of nothing.

Senator PROXMIRE. Well, the centerpiece of your program seems to be a risk-based insurance premium.

Mr. GRAY. That's right.

HIGHER PREMIUMS MAY CAUSE RISK TAKING

Senator PROXMIRE. There's no denying risk-based premiums would be somewhat more equitable than the present system, but even your own staff doesn't believe that risk-based insurance will do very much to avert insolvencies. It might even increase them. Here's what they say:

> By comparison with a fixed-rate premium, a risk-sensitive premium imposed when the insurer cannot close insolvent institutions, may tend to increase risk taking by insolvent or nearly insolvent institutions because with a fixed-rate premium the institutions do not need to recover additional premium costs.

In other words, weak institutions will make even riskier loans in order to make up the cost of higher deposit insurance premiums.

Do you agree with this assessment of risk-based premiums by your own staff?

Mr. GRAY. I will say the following in an effort to try to answer your question. The reason we have made the risk premium scheme that we've proposed as the centerpiece of our program, as I tried to suggest in my opening statement, is to carry out our goal to find a way to halt losses by pricing the risk of loss to the FSLIC. If we can do that and create a fairer allocation of the cost of risk throughout the industry to members of our fund, then I think the industry will see a greater light at the end of the tunnel out there and will be willing on a more widespread basis, to find a means to replenish the FSLIC's reserves clearly, we do not like to carry insolvent institutions on our books—but I think that could be handled on a cash flow basis over time if the industry had the reason to believe—the necessary confidence that we were reforming the system, so that those institutions willing to engage in greater risks could only do so if they were willing to pay higher prices to do that, higher premiums to do that. All of this would give some hope to the industry that we could work ourselves out of these problems over time.

I don't have the wisdom to know how else to do this other than that, and I think that is a very good approach under the circum-

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stances to give our industry the confidence that we could over time work out of this and we could recapitalize the industry. There have been proposals made already by the staff of the U.S. League of Savings Institutions to replenish the reserves through a deposit setaside that would produce $10 billion which would at least be available to the FSLIC. We have not taken a position on whether that's the best approach. That's what the NCUA received in legislation last year and it certainly is an option to consider, but there are no easy answers. There are no panaceas in dealing with this problem. We happen to be the officers of the U.S. Government trying to deal with the problem on behalf of the Congress as best we can under the circumstances, in all honesty.

Senator PROXMIRE. Mr. Chairman, my time is up.

The CHAIRMAN. Before I turn to Senator Hecht, just one comment. Senator Proxmire is absolutely right in the figures of the potential loss out there of some $16 billion versus $6 billion, but I didn't want to leave that hanging in the context of this questioning. That would assume that you had these failures all occur at once or in a very brief period of time.

Mr. GRAY. That's true.

The CHAIRMAN. It is not realistic that it would happen. So both of you are correct, but I didn't want people to get the impression that suddenly there's going to be three times the amount of claims as there is money. When Chairman Pratt was there he and I suffered through 1982 together with more than 300, as I remember, institutions merging. That was more than at any time in the history. Even then, you were not having all of this come together at the same time through assisted mergers, cutting down the costs to the FSLIC, rather than just going in and saying, all right, you're insolvent, we're going to pay out everybody with $100,000. I just wanted to make that point correct. It's not that Senator Proxmire was incorrect in his figures, but I didn't want to leave it hanging because the likelihood of all of it occurring at one period of time is very, very remote.

Senator PROXMIRE. Mr. Chairman, of course, you're absolutely right. There's no way you're going to have a $16 billion obligation occur tomorrow morning, or in 1 month or maybe 6 months, or 1 year. But when you've got this enormous disproportion between the $16 billion obligation and the $6 billion fund, obviously the fund isn't adequate. You have to be very sensitive to that and aware of it. It seems to me that that's the danger signal and that's why Mr. Isaac's notion of merging the FDIC and FSLIC funds should be carefully examined. You raise some excellent objections to it, but when you have this enormous obligation we have to consider all possibilities. The cost is not going to happen tomorrow, it's not going to happen next week or in 1 year, but it's something that gives all of us a great deal of pause.

The CHAIRMAN. Well, let me say that I agree completely and that's why we're holding these hearings. I just didn't want the message to go out of here and suddenly we have people running into every savings and loan across the country to withdraw their savings because it's all going to go boom. It's a long-range problem that we must find a solution to and better balance it. It is out of

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balance, but it's not a problem that's going to occur quickly. That's the message I did not want to get out.

Senator PROXMIRE. Mr. Chairman, could I get unanimous consent to put in the record the study for the Board that I referred to?

The CHAIRMAN. Certainly.

[Response to written questions of Senator Proxmire from Chairman Gray and study for the Board follow:]

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM EDWIN GRAY

QUESTION 1:

The National Council of Savings Institutions is strongly opposed to any thrift test for savings institutions. They argue that a thrift test will force them into making too many unprofitable mortgage loans and that it is inconsistent with the trend towards financial de-regulation set by the Congress over the last several years.

What is your response to these arguments against the thrift test?

ANSWER 1:

I believe it is fundamentally misguided to frame a debate about the propriety of a "thriftness" portfolio test upon simplistic labels such as "reregulation" or "deregulation." Indeed, that approach ignores the fact that the Congress itself, in enacting the Garn-St Germain Act of 1982, expressly set out a "Thriftness" test — based on the 60% portfolio composition test of I.R.C. 7701(a)(19)(C) linked to the bad debt deduction — to determine the authority of a thrift to be acquired by a diversified unitary savings and loan holding company and to determine the authority of federal savings and loans to engage in interstate branching in non-supervisory circumstances.

While the Board has strong reservations about the particulars of the "thriftness" test incorporated in S.2851, as passed by the Senate last year, we strongly support the principle of such a test. I believe that an appropriately structured asset composition test, such as the one contained in S.759, the Board's legislative proposal, provides the most equitable and realistic means of preserving the specialized function of thrifts by distinguishing such institutions and extending to them unique regulatory benefits based on a dedication to housing finance and other housing-related investments.

We believe that such a test is a vital part of any changes in bank or thrift regulatory authorities because it recognizes the reality that thrifts and banks continue to function quite differently in the marketplace. Such a test assures that institutions with a substantial commitment to housing finance will continue to function within a framework specifically fashioned to aid their mission. As I have frequently stated, if thrifts ever did become the equivalent of commercial banks, I do not believe there would be any sound basis for maintaining the Federal Home Loan Bank Board, the Federal Home Loan Bank System, or the Federal Savings and Loan Insurance Corporation in a separate regulatory framework.

In my view, every institution with a thrift charter, whether state or federal, should be able to pursue diversification options. However, where such diversification involves abandoning home finance as a primary mission, an institution should not be allowed to compromise the purposes of the separate thrift regulatory structure by freely availing itself of

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its benefits. An appropriate asset test would resolve this problem by denying future bank-like thrifts the benefits which ought to only accompany a substantial housing finance focus.

In my view, any asset composition test which reforms the current regulatory structure for insured depository institutions must be guided by three basic principles.

First, any such legislation must acknowledge the very basic differences, in statutory authorities and operating functions, between thrifts and banks. I reject any contentions that the intent or effect of the Garn-St Germain Act was to somehow transform thrifts into banks. Last year, thrifts closed a record $165.6 billion in mortgage loans, 20% more than in 1983. At the same time they increased their share of permanent loans originated on 1-4 family property to 48% from 40% in 1983. While FSLIC-insured institutions have continued to increase their holding of non-mortgage loans authorized by recent legislation, such loans still accounted for only 3.2% of assets as of March of this year.

Second, any reform proposal must preserve and enhance, not reduce, the attractiveness of the thrift charter, to encourage the flow of new capital into the industry and to facilitate profitable use of the supplementary Garn-St Germain powers. This is especially important given the weakened condition of the thrift industry and its continuing sensitivity to interest rate changes.

Third, any such proposal should reaffirm the long-standing Congressional commitment to preserve an independent regulatory and deposit insurance framework for true housing-oriented thrift lenders, with regulatory power over such lenders and their holding companies vested exclusively in the Bank Board.

The Bank Board does, however, have grave concerns that without certain revisions, the S.2851 housing test could thwart the primary goal of the Garn-St Germain Act to revitalize and strengthen home lenders, by seriously compromising the ability of thrifts with a strong housing commitment to raise capital through conversions, to restructure and strengthen their portfolios, to reduce interest rate risk through appropriate diversification, and to survive and prosper in a variety of economic environments.

Under S.2851, the 60% "thriftness" portfolio test would be linked to unitary diversification as well as eligibility of a thrift to receive advances from the Federal Home Loan Bank system.

Section 107 of S.2851 would provide that liquidity investments enumerated in the Federal Home Loan Bank Act, as well as a certain volume of mortgage banking originations, could be included in the 60% thrift portfolio test, but could not exceed 10% of the institution's assets.

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The Board is strongly opposed to any mandatory legislative ceiling on liquidity as a component of the qualifying thrift portfolio test. Maintaining a portion of investments in liquidity items is neither a luxury nor a diversion from the home finance role. To the contrary, given the unstable economic conditions confronting thrifts since 1981, and the extremely cyclical nature of housing demand, a thrift must have maximum flexibility in its daily operations to keep a portion of assets in cash and items that are easily liquidated. Moreover, Board regulations currently require Federal Home Loan Bank members to maintain liquid assets in an amount equal to at least 5.0% of their deposits and short-term borrowing. To have any significant operating flexibility and to avoid violating this regulatory requirement, individual institutions must, on the average, carry liquidity well in excess of this amount. In recent years, the aggregate industry liquidity ratio has been over 10 percent.

Maintenance of liquidity is thus a critical management tool which undergirds a thrift's continued ability to deliver housing credit, especially with regard to its continued eligibility for the benefits available through Federal Home Loan Bank System membership.

The Board is similarly opposed to the proposed aggregation of credit for mortgage originations with liquidity under an arbitrary 10% ceiling. This approach is a double-edged threat to efficient management. In a period of low housing demand and rising rates, this approach could force managers to forego profitable loan sales — and the potential to offset losses arising from maturity mismatches which continue to threaten industry viability -- if the cash generated could not be profitably deployed into non-liquidity assets allowing maintenance of qualifying status.

Eliminating these restraints is thus vital to the future viability of thrifts, and in our view would pose no threat to the industry's central housing mission. The Board would have ample authority under S.2851 to impose regulatory restraints on liquidity investment and secondary market activity to thwart potential misuse.

QUESTION 1 - FOLLOW-UP:

Will you provide this Committee with statistics on the number of thrift institutions that will meet the thrift test under last year's bill, S.2851, and how many will meet the test under the revised language the Bank Board is recommending.

We can provide only rough estimates of the number of FSLIC-insured institutions that would fail to meet the thriftness test contained in S. 2851 and the alternative test recommended by the Bank Board because of the data items currently reported to the Board by insured institutions in some instances are defined in a manner inconsistent with the thriftness test definitions. Approximations based on data for December 1984, however, indicated that about 450 institutions (14 percent of FSLIC-insured firms) would have failed the S. 2851 test, while only about 115 firms (4 percent) would have failed the Board's proposed test.

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QUESTION 2:

As you know, the savings and loan holding company act limits the activities of savings and loan holding companies in the same manner that the bank holding company act limits the activities of bank holding companies.

However, there is a loophole in the savings and loan holding company act. The loophole allows a savings and loan holding company to engage in any activity it wants provided it does not own more than one savings and loan association. Bank holding companies used to have a similar loophole, but Congress closed it in 1980.

Is there any useful purpose served by the loophole in the savings and loan holding company act, and if not, why shouldn't it be closed?

ANSWER 2:

Your question appears to be founded on the faulty premise that thrifts and banks are essentially the same, and that their holding company structures should serve identical purposes. 1/ This is simply not so.

At the outset, it is important to distinguish the history and purpose of the one-bank holding company "loophole" and existing authority for unitary holding companies with broad diversification powers.

Until the amendments of 1970 to the Bank Holding Company Act ("BHCA"), the parent of a single bank was totally outside the scope of the Bank Holding Company Act, and its primary purposes of preventing undue concentration of control of credit and segregating banking and commercial enterprises. The Congress believed in 1956 that no need had been shown to subject such companies to regulation to carry out the basic goals of the BHCA. Between 1966 and 1970, a significant upward trend in assets held by such holding companies — and in particular affiliations involving numerous banks with assets exceeding $1 billion, including the nation's six largest banks — led Congress to reassess the potential for abuse in such affiliation. Consequently, the 1970 amendments closed this "loophole." See, S. REP. 91-1084, 91st Congress, 2d Sess. (1970), reprinted in 1970 U.S. CODE CONG. & AD. NEWS 5520-5522.

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1 It is also crucial to note the fallacy of drawing an analogy between formerly unregulated one-bank holding companies and unitary savings and loan holding companies. Both unitary and multiple savings and loan holding companies have restrictions on their operations which have no parallel in bank holding company law and which circumscribe the flexibility of savings and loan holding companies to a much greater degree than bank holding companies. These restrictions, which relate to affiliate transactions and debt issuance, are set forth in detail in Appendix A to these Questions and Answers.

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The history and purpose of the savings and loan unitary diversification option are fundamentally different from the former one-bank holding company exemption. More than a decade ago, the Congress established a separate holding company structure which was unique to thrifts. This structure enables holding companies to conduct a diverse array of activities that lend strength to their subsidiaries and permit different types of companies to acquire thrifts. The greater diversity enjoyed by thrift unitary holding companies, when compared with bank holding companies, reflects the Congress' longstanding recognition of the need to supplement the limited asset authority of thrifts.

Before enacting the Garn-St Germain Act, Congress completed a review of the entire savings and loan holding company structure. By deciding to retain that structure in its present form, Congress clearly reaffirmed its belief that the added flexibility provided by that format was, indeed, an appropriate supplement to the limited asset powers of thrifts. Thus, the only restrictions imposed by Congress on unitary holding companies were aimed at ensuring the continued focus by the thrift subsidiary on the traditional home financing function.

The unitary holding company structure has worked well to date and serves as an important source of capital infusion to the industry, by enabling holding companies to conduct a diversity of activities that lend strength to their subsidiaries, and by permitting different types of companies to acquire thrifts. As the chief federal regulator of the savings and inquiry on my part, that the current unitary holding company structure has led to abuses that would warrant the kind of significant legislative change being proposed to this Committee.

Opponents sometimes point to the greater diversity enjoyed by thrift unitary holding companies when compared with bank holding companies. However, at the risk of being redundant, this difference specifically reflects Congress' longstanding recognition of the need to supplement the limited asset authority of thrifts and of the fact that, because of the limited commercial asset powers of thrifts, ownership does not raise the credit allocation issues present in the ownership by commercial banks of commercial enterprises. Given these differences, we can see no basis for emasculating unitary savings and loan holding companies by removing their current flexibility in favor of the more limited "laundry list" afforded multiple savings and loan holding companies. There is no justification for this change, if the goal is to truly balance the authorities of the bank and thrift industries.

Clearly, scaling back the options of thrift holding companies in such a drastic way as you propose would make thrifts far less attractive to the capital markets and to investors. Any reduction of thrift asset powers, or a significant diminution of structural flexibility, would seriously undermine the ability of thrift institutions to generate counter-cyclical earnings streams to offset interest rate swings. Given the Congressional mandate that thrifts maintain their commitment to

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housing lending thrifts, unlike banks, are uniquely susceptible to the cyclical nature of housing demand and to the dangers of interest rate risk. By depriving thrifts of important asset powers and structural "elbow room" to balance their portfolios through affiliation with unitary holding companies, the proposal you have suggested would have the effect of driving thrifts toward the same asset liability mismatch trap that nearly proved fatal to the industry during the last several years.

And any reduction in the structural flexibility of thrifts would diminish the value of a thrift charter. This could impede the valuable mutual-to-stock conversion process, or, at the very least, diminish the amount of capital that may be raised in conversions.

We believe such changes could translate into a "domino" effect of negative consequences for the industry: reduced capital invested, leading to lower thrift net worth, increased pressure on the FSLIC insurance fund, and increased federal expenses to stave off failures. We believe such results must be avoided by leaving the current powers of thrift holding companies intact.

Finally, notwithstanding our general support for retaining the unitary option, the Board does believe that reform is vital in one area — the affiliation of thrifts with underwriters or marketmakers of corporate securities. We believe the most appropriate approach in this regard is set out in S.759, which would impose an explicit ban on such affiliations, with no grandfathering of existing relationships.

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QUESTION 3:

The net worth certificate program was originally designed to help institutions overcome a temporary interest rate spread problem. However, most of the problems of the FSLIC in the next year or two seem to concern credit risk rather than interest rate risk. There is no way a net worth certificate program can help an S&L recover from making too many bad loans. If this is correct, why do we need any net worth certificate program at all? Why don't we simply let the program expire?

ANSWER 3:

While credit risk problems are coming more to the forefront, there still exist many institutions which continue to suffer from interest rate spread problems. Spread problems cannot be solved overnight, even with a continuation of lower interest rate levels. These institutions will need a significant period of time or restructure their asset portfolios to the point necessary to reach a stable and profitable position. The Net Worth Certificate Program provides an opportunity for such restructuring and allows the participating institutions to continue to serve their communities. Indeed, absent the program, many of the participating institutions would have ceased to exist as independent entities.

The program has the added benefit of reducing the possible exposure to the FSLIC fund. I strongly urge the continuation of the Net Worth Certificate Program.

QUESTION 4:

Can you give us any examples of financial institutions that have successfully recovered after receiving net worth assistance from the Federal Home Loan Bank Board?

Please provide the Committee with statistics on the net worth certificate program, including the so-called Phoenix program. These statistics should indicate the level of capital before assistance, the amount of assistance and the current level of capital.

ANSWER 4:

Select Institutions Participating in the
Net Worth Certificate Program
as of 5/31/85

Those institutions that reported net income for their most recent yearend and/or reported year-to-date net income.

District	Name
1	Milford FS&LA
2	First FS&LA of Montclair
2	State Savings, FA
2	Columbia S&LA, FA
2	Llewellyn-Edison S&LA
2	Fellowship S&LA
2	Brooklyn FS&LA
2	Salamanca FS&LA
2	Columbia Banking, FS&LA
2	Shadow Lawn S&LA
2	North Jersey S&LA
2	White Horse S&LA
2	Newton S&LA
2	Druid Hill FS&LA
4	First FS&LA
4	Railroadmen's FS&LA of Indianapolis
6	Shelby FS&LA
6	Peerless FS&LA
7	Charleston FS&LA
7	Capitol FS of America
7	Mendota S&LA
7	Batavia S&LA, FA
7	Horizon FSB
7	First FS&LA of Madison
7	Security S&LA, FA
7	Home FS&LA of Elgin
7	Morton FS&LA
7	Loves Park S&LA
7	Home FS&LA of Harlan
8	First FS&LA of Alexandria
9	Terrebonne S&LA
9	American Charter FS&LA
10	First FS&LA of Coffeyville
10	Nile Valley FS&LA
10	First FS&LA
12	

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QUESTION 5:

In an article in the February issue of Savings Institutions, a publication of the U.S. League, Dennis Jacobe notes that some thrift lenders are contemplating a return to fixed rate lending in order to earn the higher immediate spreads on fix rate loans. He concludes by warning that "It would be a terrible thing to see the progress of the last couple of years dissipated and the business returned to fixed rate mortgage lending. Still, we are often our own worst enemy in this business, especially when the high-paid salesmen on Wall Street provide the rationale."

Do you agree with Mr. Jacobe's analysis, and if so, what steps is the Bank Board taking to prevent a return to the discredited "borrow-short, lend-long" strategy?

ANSWER 5:

The Bank Board has noted a favorable trend in the origination of adjustable rate (ARMS) mortgages in recent months. Contrary to popular myth, the fixed-rate mortgage has not reclaimed its former dominance of savings institution mortgage activity. Indeed, the ARM is alive and well and trending upward.

The ARM share of conventional home mortgages on single-family residences made by FSLIC-insured institutions rose to 61 percent in early July, up from 59 percent in early June ;and 52 percent three months earlier. The July ratio was the highest since last November. The continuing dominant role played by ARMS--especially in light of recent declines in mortgage rates—belies the notion that lower mortgage rates make fixed-rate mortgage preferable to ARMs in the eyes of most homebuyers. Seen together, recent profitability; moderate, not excessive growth in the industry; and continued significant emphasis on ARM mortgage originations by thrifts are all persuasive evidence that the savings institutions industry can adapt, and is adapting, to a rapidly changing environment.

Despide the very real difficulties a segment of the thrift industry is experiencing, and the continuing, critical need to reform, strengthen and alleviate strains on the thrift deposit insurance system, the long-term picture for a great majority of thrifts looks brighter today than at anytime in recent years.

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Question: Net Worth Certificates

(Senator Proxmire)

Chairman Gray, the Net Worth Certificate program seems to have been a colossal failure. According to the GAO, the institutions receiving net worth assistance are worse off today than they were in 1982 when the program was started. Can you give me one good reason why the program should be extended?

Answer:

We assume that your concerns are based on figures taken from Appendix IV of the 7/3/85 GAO report titled "Federal Banking Agencies are Adequately Examining Net Worth Certificate Program Applications." Appendix IV showed that the aggregate regulatory net worth and the aggregate regulatory net worth without net worth certificate assistance of 51 FSLIC-insured institutions with net worth certificate assistance outstanding as of June 30, 1984, and which had participated in the Bank Board's net worth certificate program since its inception in December 1982 had decreased by 8.8% and 23.2%, respectively.

As of June 30, 1985, four of the 51 institutions included in the GAO study had merged into other institutions and two other institutions had been acquired by other institutions subsequent to June 1984 but prior to June 1985. As shown by the attached Exhibit 1, of the 45 institutions remaining, their aggregate regulatory net worth had increased 19.0% from June 1984 to June 1985 and 8.5% from December 1982 to June 1985 while their aggregate regulatory net worth without net worth certificate assistance had increased 19.8 % from June 1984 to June 1985 but had decreased 8.1% from December 1982 to June 1985.

The original intent of the net worth certificate program was to give institutions time to restructure their balance sheets to lessen the asset/liability maturity mismatch which resulted in the late '70's and early '80's from liability deregulation without concurrent authority for asset diversification. The improvement in the regulatory net worth position, with and without net worth certificate assistance, from June 1984 to June 1985, of the remaining institutions included in the GAO study indicates that the program is not a colossal failure but is, in fact, working as intended. Therefore, we believe that this evidence supports our contention that the program should be extended so that institutions operating in the currently favorable interest rate environment can be given additional time to restructure their balance sheets.

Exhibit 1

Regulatory Net Worth for FSLIC-Insured NWC Institutions
for December 1982, June 1984, and June 1985

	December 1982 ($ mil.)	June 1984 ($ mil.)	June 1985 ($ mil.)	% change Dec. 1982 to June 1985	% change June 1984 to June 1985
Regulatory net worth NWC institutions	260	237	282	8.5	19.0
Regulatory net worth without NWC assistance NWC institutions	211	162	194	-8.1	19.8

Sources: December 1982 and June 1984 figures are from Appendix IV of 7/3/85 Report (GAO-GGD-85-33) and include 51 institutions identified by GAO/GGD. June 1985 figures are from the FHLBB Quarterly Report System and include 45 institutions (51 above, minus 4 merged into other institutions and 2 acquired by other institutions subsequent to June 1984 and prior to June 1985).

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Question: Net Worth Certificates (Senator Proxmire)

If we do extend the (Net Worth Certificate) program, why shouldn't we give the Bank Board a mandate to phase out RAP accounting and require all savings and loan associations to achieve a 5 percent capital ratio under GAAP in 5 or 7 years, or otherwise be liquidated or merged out of existence?

Answer:

The principal RAP/GAAP difference is the deferral of losses sustained on loans sold in the effort to restructure the balance sheet of the industry. Since this authority under RAP does not extend to new loans, this constituent of RAP net worth is self-liquidating over a period of time. While the Bank Board intends to move to eliminate unnecessary other RAP/GAAP differences as economic circumstances permit, the amounts involved are relatively not material. In addition, while moving the savings and loan industry to GAAP accounting would improve comparability of financial statements, GAAP is still based upon historical cost accounting and therefore is flawed for a financial industry that has an asset inventory for which the true value fluctuates on the vagaries of an exogenous factor, e.g. market interest rates.

Setting a substantially higher capital requirement does not necessarily mean that the industry, or substantial portions thereof, can meet the requirement. The publicly-held stock companies (which already report under GAAP) have the possibility of raising additional equity capital through secondary offerings of their stock. The mutual institutions, which constitute a significant portion of the industry, can only accumulate GAAP net worth through earnings. If the interest rate scenario is favorable over the next 5 to 7 years, they can rebuild their capital base. If it is not, the ability to meet a 5 percent capital requirement is questionable for many of these mutual institutions.

If the economic situation over the next few years is such that a substantial number of institutions cannot achieve the 5 percent benchmark, the FSLIC could be facing a problem of enormous magnitude in liquidating them or merging them out of existence. Almost by definition, the institutions affected would be borderline operations for which merger partners would be difficult to find. If the statutory responsibility were imposed on the Board to liquidate institutions that are technically solvent but deficient as to a congressionally defined 5 percent capital requirement, the FSLIC would face implementation problems.

If the net liquidation value of such institutions was insufficient to pay off the depositors, the FSLIC could suffer substantial losses. This negative value is a possibility even under GAAP due to the historical cost basis problems discussed above. The stockholders in a stock institution would likely have a basis for legal action against the FSLIC if their investment in a technically solvent going concern were to be wiped out by our actions; a loss that would be compounded by the loss of their anticipated future stream of dividends. In all cases, there would be a reasonable likelihood that the management of the institutions would file suit against the FSLIC for unlawful deprivation of livelihood.

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Question from Senator Proxmire

How do you assess the effect of the House bill mandating nationwide interstate branching in five years for banks. Will this make it more difficult to dispose of failing savings and loan associations and thus more costly to FSLIC?

Answer:

For federally chartered, FSLIC-insured thrifts, the Bank Board has complete authority to grant interstate branching rights. However, for state-chartered, FSLIC-insured thrifts, state agencies, rather than the Bank Board, have the power to approve branching. In the recent past, the Board's policy has been to permit federally chartered associations to branch interstate only when such branching results from a merger with a troubled institution. This policy limits branches in such cases to the states in which the acquired institution had a presence prior to the merger. Interstate branching in nonsupervisory cases has generally not been approved, nor have supervisory mergers or acquisitions commonly involved expansion by the resulting institution beyond the states in which the former associations were located.

The Supreme Court has recently affirmed the validity of interstate regional reciprocity agreements for commercial banks. Twenty-two states have passed some form of banking reciprocity law. These reciprocity agreements generally allow a bank from a state which has a reciprocity law to purchase a bank in another state that has a similar law.

These regional pacts make it more difficult to dispose of failing savings and loan associations and thus more costly to the FSLIC. Passage of legislation permitting nationwide interstate branching for banks will make it even more difficult to dispose of institutions. Since the majority of buyers of the FSLIC cases are thrifts seeking an interstate franchise, the value of savings and loan associations will be reduced as states open their doors to other institutions. Thus, the FSLIC's ability to resolve cases through mergers or acquisitions will be hampered.

Interstate acquisitions in 1981 and 1982 were estimated to save the FSLIC 60% over the cost to resolve the same cases intrastate. In 1984 alone, it is estimated that the use of interstate acquisitions saved the FSLIC $235 million over intrastate acquisitions. If the value of interstate franchises are lowered because of free bank entry, the FSLIC will have to spend more to resolve problem cases.

Given these concerns, we believe that to insure systemic soundness any statutory liberalization of interstate limits on bank operations must be deferred until appropriate action is taken to reform the insurance premium scheme and recapitalize the fund.

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Question: Market Value Accounting (Senator Proxmire)

A former head of FSLIC, Brent Beasley is going to follow you today. I would like your comments on his recommendations. He says that both RAP and GAAP accounting are highly misleading and that we should require institutions to convert to market value accounting. He points out that the securities industry must mark their assets to market every month and that this has been a useful discipline. Why can't we apply the same discipline to the thrift industry?

Answer:

We would prefer to identify Mr. Beasley's comment about both RAP and GAAP accounting as being highly misleading. The major area where both do present problems is in the fluctuations of the realizable values of interest-sensitive assets in response to changes in market interest rates and the concommitant impact on "true", or realizable, net worth. Under historical cost accounting, which is the basis for both RAP and GAAP, these changes in value are not recognized until the disposition of the assets.

Application of market value accounting to the financial industry has been a source of controversy within both the thrift industry and the accounting profession because of the difficulty of assessing the current or market value of assets not actively traded and its direct conflict with the principle of historical cost. Market value accounting requires "marking to market" the value of an institution's loan and investment portfolio on a periodic basis and realizing either the gain or loss against net worth. In its simplest application and for purposes of illustration, market value accounting would require an institution with a thirty year mortgage loan originated several years ago at a contract and market interest rate of nine percent to be "marked to market." Under this concept, the mortgage loan would be discounted to reflect the change in value that the market would place on the difference between the nine percent original rate of return and the current prevailing interest rate for a similar mortgage loan.

Advocates of this method of accounting argue that a truer picture of the value of the institution results from use of market value accounting. However, market value accounting is in direct contradiction to the historical cost principle of Generally Accepted Accounting Principles ("GAAP"). Additionally, there exists a continuing debate over whether long term assets, such as nonconforming mortgages without an actively trading secondary market, should be treated as long term investments with an acceptable, though not current, rate of return, or treated as marketable assets to be "marked to market." However, it should be noted that when a thrift institution has a portion of its assets in a trading portfolio comparable to that of a securities dealer (as opposed to assets in the investment portfolio where the intent is to hold the securities to maturity), mark-to-market accounting is required for the trading portfolio under GAAP and the Board's regulations.

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Because of the continuing debate over the appropriate use of this method of accounting, the difficulty in administratively maintaining and updating books and records, and the difficulty of accurately assigning value to assets with no active market in which to trade or receive market value, the Board is of the opinion that market value accounting should not be used for thrift institutions at this time. As the theory evolves, it may be appropriate to apply such method to thrift institutions eventually; however, the current level of understanding does not support the present application of market value accounting to thrift institutions.

If, however, future developments are such that the problems with market value accounting can be resolved, we believe that it should be applied to all financial institutions including commercial banks rather than solely to thrift institutions.

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Question from Senator Proxmire

As you know too well, a recurring problem of the savings and loan industry has been a mismatch between the maturity of their assets and liabilities. Incredibly, the Bank Board had no information or reporting system to collect data on the size of this mismatch for each institution. I was pleased that you moved to install a better reporting system in early 1984.

This new reporting system has been in effect for over a year. What can you tell us about the interest-rate mismatch in the savings and loan industry? Is it getting better or is it getting worse?

Answer:

Through the use of adjustable-rate mortgages (ARMs), mortgage-backed securities, and interest-rate swaps, the savings and loan industry has steadily worked towards reducing its interest-rate risk exposure. The Bank Board has encouraged and facilitated these adjustments. As a result, our new reporting system indicates that the interest-rate risk exposure of the industry has declined. Between March 1984 and March 1985 the cumulative interest-rate gap under three years in maturity as a percent of assets declined significantly from 45% to 33%.

The Bank Board has strongly advocated the use of ARMs as a fundamental tool for reducing interest-rate risk. The rising proportion of ARMs among all loans closed--from 26 percent in May 1983 to 75 percent in August 1984--indicates wide acceptance by the market. Although current low interest rates make ARMs slightly less desirable to borrowers, the adjustable-rate mortgages remains the primary method to hedge interest-rate risk. Preliminary June 1985 figures indicate that ARMs now account for over 40 percent of the single-family mortgages held by thrifts. This is a substantial increase from the March 1984 figure of 26 percent.

Utilization of the secondary mortgage market has also proven effective in reducing maturity mismatches. By June of 1985, thrifts held approximately 10 percent of their assets--over $102 billion--in mortgage-backed securities. Because these instruments are more liquid than whole mortgage loans, portfolios including them can be adjusted at a lower cost in the event of rising interest rates.

In July of 1984, the Bank Board authorized S&Ls to establish finance subsidiaries for the purpose of issuing collateralized mortgage obligations (CMOs). The CMO represents an innovative improvement over traditional mortgage-backed securities. By refining the method for distributing mortgage prepayments, the CMO has proved attractive to the market. As such, CMOs provide thrifts with a relatively low cost source of funds. In addition, like other mortgage-backed securities, CMOs allow a thrift to restructure its portfolio to be less interest-rate sensitive.

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Finally, the increasing ability of thrifts to swap fixed-rate interest payments for variable-rate payments has significantly contributed to a reduction in interest-rate risk. Savings institutions can now undertake an "interest-rate swap" which serves to reconcile the differences in asset and liability payment structures. The Bank Board, in 1984, presented interest-rate swap guidelines that have helped open this avenue to all institutions. District banks can now support financially weak institutions in swap arrangements and act as swap counterparties to smaller institutions, boosting their collateral to necessary levels. By the end of 1984, eight district banks already held $2.3 billion outstanding in swaps with their members.

Although none of the above measures alone could fully insulate the industry--and the FSLIC--from interest-rate risk, in concert they provide effective and flexible means to reduce mismatches in portfolio payment structures and maturities.

Question: Conversions of banks to savings and loan associations

(Senator Proxmire)

Recently a billion dollar bank in Florida converted from a commercial bank to a savings and loan association in order to take advantage of the looser capital requirements imposed by the Bank Board and the more liberal RAP accounting provisions. Chairman Issac has testified he expects many similar conversions to take place in the future and is worried that it will impair the ability of the FDIC to raise the capital standards for banks.

Do you share Chairman Issac's view that this is a serious problem, and if so, what does the Bank Board propose to do about it?

Answer:

We do not share Chairman Issac's concern simply because commercial banks converting to savings and loan associations are ultimately required to adhere to the higher capital requirements imposed by the FDIC.

The Board has recently distributed a memorandum which makes clear that any FDIC-insured Federal Savings Bank with a ratio of primary capital to adjusted total assets of less than three percent is operating in an unsafe or unsound condition. Such condition calls for the imposition of a supervisory agreement which requires the savings bank to increase its capital to the FDIC's present standards of 5.5 percent primary capital as a ratio of assets and 6 percent combination primary and secondary capital as a ratio of assets.

Thus, the Board has in effect measures by which to ensure retention of the FDIC's higher capital requirements.

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QUESTION

As you know, there is a broad consensus in both the House and the Senate that the non-bank bank loophole should be closed. And yet after seven months into the current session of Congress, neither House has seen fit to act. How urgent is it to FSLIC that this loophole be closed promptly? Are we costing FSLIC and ultimately the U.S. Treasury money for every day we delay in closing the non-bank bank loophole?

ANSWER

The Bank Board supports the elimination of the nonbank bank loophole, which threatens the FSLIC's ability to use effectively its statutory authority to reward acquirers of failing thrifts with interstate franchise rights through the use of the bidding procedure. Congress enacted this authority as part of the Garn-St Germain Act of 1982 to increase the FSLIC's flexibility in responding to supervisory problems and to permit it to better husband its resources. Such flexibility for the FSLIC is a national priority that is more important today than ever before.

The proliferation of nonbank banks, however, has virtually eliminated any incentive for banks and bank holding companies to obtain interstate rights, or for other corporations to acquire a depository institution by acquiring a weakened thrift. Until late last year, when the Office of the Comptroller of the Currency lifted its nonbank bank moratorium, the FSLIC was successful in reducing its costs by arranging acquisitions rather than liquidations. While it is impossible to know precisely what effect this loophole is having on the FSLIC's ability to resolve severe thrift problem cases, former potential bidders that were previously willing to negotiate seriously for interstate operating rights have largely disappeared. Accordingly, the Bank Board believes it is crucial to the health of the FSLIC to enact legislation to close the nonbank bank loophole as soon as possible.

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Question from Senator Proxmire

According to the Bank Board, there are over 400 savings and loan associations that are insolvent under generally accepted accounting principles. These associations have combined assets of over $100 billion. It has been estimated that the loss to FSLIC would be at least $15 billion if these associations are liquidated. I would like each member of the panel to answer three questions:

1) If nothing is done for the time being, will the potential FSLIC lo s get larger or smaller?

2) When should these insolvent institutions be closed?

3) How should the losses to FSLIC be covered?

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Answer:

As of December 1984, 434 FSLIC-insured thrift institutions were insolvent under generally accepted accounting principles. These institutions comprised $107 billion in assets. By June 1985, 461 institutions, comprising $113 billion in assets, were insolvent. As a group, GAAP-insolvent thrifts have also been losing money in each recent quarter. In the fourth quarter of 1984, GAAP-insolvent institutions had net income of -$278 million. This group had net income of -$158 million and -$230 million in the first and second quarters of 1985, respectively. The increased number of insolvent institutions and their negative net income suggests that the longer the FSLIC must wait before closing these institutions, the greater will be the cost to the FSLIC.

Deciding if and when to close an institution is difficult. An institution should generally be closed when the market value of its assets declines to the market value of its liabilities. This is likely to be the case with most of the GAAP-insolvent institutions. Thus, these should be closed as soon as possible--subject to two conditions. First, institutions can only be closed as rapidly as the human resources of the FSLIC and the Bank Board allow. Bank Board personnel are working at maximum capacity to resolve the current FSLIC caseload. An acceleration in the rate of thrift closings would require additional trained personnel--something I have been petitioning Congress for for some time now. Second, the speed with which institutions can be closed depends upon the speed with which FSLIC can locate a merger partner in the case of a merger, and the speed with which FSLIC can dispose of poor-quality assets in the case of a liquidation. If thrifts are to be closed more rapidly, a larger proportion of cases will probably have to be resolved through liquidation, a method which is costlier to the FSLIC. Furthermore, an attempt to dispose of too many assets at the same time will flood the market and cause the price that FSLIC is able to obtain for each asset to be depressed. For these reasons, the closing of insolvent thrifts must be a gradual process. But as the growing number of insolvent institutions suggests, it is also clear that we must not delay in our efforts to close insolvent institutions.

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A rough estimate of the cost of closing the insolvent institutions can be calculated by assuming that the cost to FSLIC for closing this group will be about the same per dollar assets as it was for institutions closed in 1984. It cost FSLIC an average of 14.7 cents per dollar assets to resolve its assistance cases in 1984. If the 461 institutions that were GAAP-insolvent in June were closed on similar terms, the cost to the FSLIC would be about $16.6 billion.

The fact that this figure is well in excess of FSLIC's $3.2 billion in unobligated funds emphasizes the need for the rapid adoption of a re-capitalization program. Since we at the Bank Board do not print money, there are only two sources of recapitalization -- the Treasury, or the thrift industry member institutions of the FSLIC. As you know, the industry, itself, has always provided the capital necessary to enable the fund to meet its obligations. I personally strongly favor recapitalization by the industry.

One way to accomplish the recapitalization is through authority by which the FSLIC could require a deposit set aside from member institutions similar to that enacted last year for the credit unions. Under that approach, each member institution would set aside one percent of deposits at the FSLIC and they would be accounted for by the institution as an asset until such time as any portion of the deposit set-aside were drawn down. Then, that portion of the set-aside drawn down is treated as an expense to the institution. Under current conditions, the recapitalization will be resented by prudently managed institutions who perceive themselves as being penalized for the excesses of the high fliers. Hence, the success and fairness of this approach rests upon the FSLIC concurrently being granted the authority to impose a supplementary premium, where state-chartered institutions engaging in activities not allowed federals are assessed an additional premium concomitant with the additional risk they impose on the FSLIC.

As a footnote I should add that the estimated cost to the FSLIC of $16.6 billion for resolving problem cases is a present-value figure. Failures may be resolved in such a way that the cost to the FSLIC is spread over a number of years. Thus supplemental premium assessments--which have produced an additional $750 million in revenues this year--have an important role in the effort to maintain FSLIC reserves at satisfactory levels.

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INSOLVENCY AND RISK-TAKING IN THE THRIFT INDUSTRY: IMPLICATIONS FOR THE FUTURE

by

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INSOLVENCY AND RISK-TAKING IN THE THRIFT INDUSTRY: IMPLICATIONS FOR THE FUTURE*

I. Introduction

Since 1980, 510 thrift institutions insured by the Federal Savings and Loan Insurance Corporation (FSLIC) have failed.[1] Although the number of failures has declined since 1982 when a record 252 institutions failed, there were approximately 434 institutions in 1984 with zero or negative net worth and approximately 856 institutions with net worth greater than zero but less than or equal to three percent.[2] Given the large number of recent insolvencies, the FSLIC's reserves in 1984 declined significantly for the first time in its history to $5.9 billion.[3] The Federal Home Loan Bank Board (Bank Board), as operating head of the FSLIC, has sought to increase the FSLIC's reserves to deal with future as well as the recent large number of insolvencies. The Bank Board has also adopted significant regulatory changes designed to improve the condition of the industry.

The purpose of this paper is twofold. First, we put the problems facing the thrift industry, the Bank Board, and the FSLIC into historical perspective. This involves a discussion of the development of federal deposit insurance and regulation of depository institutions as well as a discussion of the causes of the recent difficulties faced by thrift institutions and the policy responses to those problems.[4] Second, we discuss the effect of the failures on the risk-taking behavior of thrift institutions and the Bank Board's policy responses to risk-taking. We conclude with some suggestions about what may be done to respond to the large and growing number of in-

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* The term "thrift industry" denotes savings and loan associations and savings banks, both federally and state-chartered, that are insured by the FSLIC.

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solvent institutions with an economic incentive to pursue extremely risky portfolio opportunities.

II. Development of Federal Deposit Insurance and Regulation of Depository Institutions

The contemporary regulatory system for depository institutions began with the creation of federal deposit insurance in 1933 for commercial banks and in 1934 for thrift institutions. Until that time, the Federal Reserve System, established in 1913 and acting as lender of last resort, was supposed to provide sufficient liquidity to prevent widespread runs on depository institutions. The Great Depression, however, demonstrated that the existence of the Federal Reserve was not sufficient to prevent runs.[5] To reduce further the likelihood of bank runs, the Federal Deposit Insurance Corporation (FDIC) was established in 1933 and the FSLIC was created in 1934.

The Federal Reserve as lender of last resort, the FDIC, and the FSLIC were not created to prevent runs *per se*. If they had been created to prevent individual bank runs, for example, they would merely have been protecting depository institutions against failure. They were instead created primarily to protect against the potential externalities, or larger social costs, created by widespread runs. The costs from such runs result from a breakdown in the intermediation function, a disruption of the payments system, and a contraction of the money supply. It is primarily to protect against these events that the Federal Reserve and the deposit insurance funds were created.[6]

In addition to the establishment of the FDIC and the FSLIC, the experience of the Great Depression led to regulations restricting the asset and liability powers of commercial banks and thrift institutions. The restrictions limited the rates of interest that could be paid on assets and liabili-

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ties and restricted competition among financial institutions of the same type as well as among different types of institutions. Hence, government-provided deposit insurance was designed to reduce the likelihood and consequences of widespread depository-institution failures through runs, while government regulations limiting activities and competition of the institutions were designed to reduce the likelihood of failures through excessive risk-taking and competition.

Government regulation was also designed to limit social costs by reducing the adverse incentives created by deposit insurance. The provision of government insurance at a flat or non-risk-adjusted rate--as has been done since 1933--creates a problem referred to as moral hazard. Financial institutions have an incentive to opt for a higher-risk portfolio than they would if the price of the insurance were positively related to portfolio risk.[7] At the same time, insured depositors have no economic incentive to monitor the activities of the institution since their deposits are insured. This means that with deposit insurance, the government attempts to reduce the potential social costs caused by runs, but at the cost of increased portfolio risk due to moral hazard and thus a greater likelihood of failure. Portfolio restrictions and other regulatory requirements are justified in this situation as a way to reduce this moral hazard.

Until the 1980s, the financial system, in general, functioned as its designers intended. Commercial banks played a distinct role in providing transactions balances or demand deposits without significant bank failures. At the same time, thrift institutions played a distinct role in providing savings deposits and thus funds for housing, also without significant failures. Beginning in the late 1970s, however, technological change, financial service innovation, changed economic conditions, and deregulation

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developed with unprecedented speed and rapidly eroded the differences among firms providing hitherto distinct financial services. Some thrift institutions began offering checkable deposits, for example, and those with state charters received expanded asset powers in several states. The result was increased competition between commercial banks and thrift institutions. At the same time, commercial banks and thrift institutions began competing more with other types of financial firms providing interest-earning deposits and checkable-type accounts. Furthermore, the first nonbank bank was established in California in 1980, resulting in de facto if not de jure interstate banking.[8]

Concurrent with these developments, the Federal Reserve Board in October 1979 announced a change in its operating procedures. Monetary aggregates were for a time given higher priority than interest rates in guiding monetary policy. Following this change, however, the money stock declined rapidly and unevenly. Then in March 1980, the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) was passed. The Act phases out deposit-rate ceilings by 1986, authorized interest-bearing checking accounts for individuals and non-profit customers of thrift institutions, and authorized federally chartered savings and loan associations to make commercial real estate loans, consumer loans, and investments in commercial paper and corporate debt securities (up to 20 percent of assets). These developments contributed to higher and more variable interest rates and increased competition among financial firms, which in turn contributed to the problems of the thrift industry in the early 1980s.

III. Thrift-Institution Failures in the 1980s

Table 1 presents the extraordinary number of thrift-institution failures during the period 1980 through 1984.[9] Before 1980, the largest number of

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Table 1

FSLIC-INSURED FAILURES: 1980-1984[a]

Year	Number of Failures (1)	Number of Insured Institutions (2)	Number of Insured Accts. of Failed Institutions (3)	Number of Insured Accts. for all Institutions (Thousands) (4)	Assets of Failed Institutions (Thousands) (5)	Assets of all Institutions (Millions) (6)	Percent of Institutions that Failed (7) = (1)/(2)	Percent of Insured Accts. Held by Failed Institutions (8) = (3)/(4)	Percent of Assets Held by Failed Institutions (9) = (5)/(6)
1980	35	4,002	161,702	92,189	2,947,877	618,466	0.87	0.18	0.48
1981	81	3,779	1,860,233	98,740	15,057,057	651,068	2.14	1.88	2.31
1982	252	3,343	2,817,742	98,986	46,836,869	692,663	7.54	2.85	6.76
1983	101	3,040	1,995,031	103,214	15,939,476	819,168	3.32	1.93	1.95
1984	42	3,167	1,439,712	108,738	9,541,217	978,514	1.33	1.32	0.98

[a] Failure is defined to be a case requiring supervisory action or FSLIC assistance. Insured accounts data encompass only the failed institutions that received FSLIC assistance.

failures in any single year was 13 in 1941. The 510 failures that occurred from 1980 through 1984 accounted for over 60 percent of the attrition that has occurred among insured thrift institutions since 1980. The total decline (including all mergers) was 835 institutions--down from 4,002 institutions in 1980 to 3,167 institutions in 1984. The total assets of the failed institutions were about $90.3 billion. The number of failures peaked in 1982 when 252 FSLIC-insured institutions, representing 7.5 percent of all institutions, failed.

Even though an unprecedented number of FSLIC-insured institutions have been closed or merged by the Bank Board since 1980, the number of insolvent and nearly insolvent institutions still operating has grown. As Table 2 shows, based on Generally Accepted Accounting Principles (GAAP), the number of institutions with estimated GAAP net worth to total liabilities less than or equal to zero rose from 17 in 1980 to 434 in 1984. The operating GAAP-insolvent institutions had assets of $107.3 billion in 1984. Nearly insolvent institutions, those with estimated GAAP net worth to total liabilities between zero and three percent, also rose dramatically--from 280 in 1980 to 856 in 1984. The nearly insolvent institutions had assets of about $350 billion in 1984. The combined assets of the 1,290 GAAP-insolvent and nearly insolvent institutions represented 45 percent of all assets of FSLIC-insured institutions in 1984.

Table 2 also shows that the number of RAP-insolvent and nearly insolvent institutions has been increasing at an unprecedented rate. In 1984, 877 institutions were RAP-insolvent or nearly insolvent, holding assets of about $307 billion or 31 percent of all assets of FSLIC-insured institutions. As Table 2 shows, RAP net worth began to deviate from GAAP net worth in 1981. The divergence between the two measures arose as the Bank Board altered

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Table 2

THE GAAP AND RAP NET WORTH OF THE WEAKEST FEDERALLY INSURED THRIFT INSTITUTIONS: 1980-1984

Net-Worth Calculations Based on Regulatory Accounting Principles[a]

Year[b]	Number of Institutions NWTL ≤ 0	Assets of Institutions NWTL ≤ 0 ($ Thousands)	Percent of Total Assets	Number of Institutions 0 < NWTL ≤ .03	Assets of Institutions 0 < NWTL ≤ .03 ($ Thousands)	Percent of Total Assets
1980	17	127,001	0.02	280	35,123,008	5.82
1981	41	7,190,973	1.12	636	129,372,410	20.22
1982	80	13,056,846	1.90	791	190,865,575	27.81
1983	54	12,613,895	1.55	770	201,451,226	24.76
1984	71	12,048,402	1.23	806	294,541,283	30.11

Estimated Net-Worth Calculations Based on Generally Accepted Accounting Principles[c]

Year	Number of Institutions NWTL ≤ 0	Assets of Institutions NWTL ≤ 0 ($ Thousands)	Percent of Total Assets	Number of Institutions 0 < NWTL ≤ .03	Assets of Institutions 0 < NWTL ≤ .03 ($ Thousands)	Percent of Total Assets	Number of Institutions 0 < NWTL ≤ .05	Assets of Institutions 0 < NWTL ≤ .05 ($ Thousands)	Percent of Total Assets
1980	17	127,001	0.02	280	35,123,008	5.82	1,357	241,083,868	39.9
1981	65	17,303,469	2.70	653	126,666,356	19.80	1,834	379,804,220	59.4
1982	201	48,716,430	7.10	842	204,252,098	29.77	1,824	504,221,332	73.5
1983	287	78,906,404	9.70	883	242,667,975	29.82	1,770	555,963,440	68.3
1984	434	107,319,626	10.39	856	350,360,796	34.54	1,656	675,539,320	69.1

[a] RAP Net Worth includes: Preferred Stock; Permanent, Reserve or Guaranty Stock; Paid-In Surplus; Qualifying Mutual Capital Certificates; Income Capital/Net Worth Certificates;[1] Qualifying Subordinated Debentures;[1] Appraised Equity Capital;[1] Reserves; Undivided Profits (Retained Earnings); and Net Undistributed Income.

[1] Not included in RAP net worth 12/82.

[b] December Semiannual Data for 1980-1983 and December Quarterly Data for 1984.

[c] Estimated GAAP Net Worth includes: Preferred Stock; Permanent, Reserve, or Guaranty Stock; Paid-In Surplus, Reserves; Undivided Profits (Retained Earnings); Net Undistributed Income; Less: Deferred Net Losses (Gains) on Loans Sold;[1] Deferred Net Losses (Gains) on Other Assets Sold.[2] The data collected by the Board do not include all data needed to calculate GAAP net worth. As a result, the estimated GAAP net worth may slightly overstate or understate actual GAAP net worth.

[1] For periods prior to 3/84, deferred losses sold is an estimate.
[2] Not collected until 3/84.

accounting for income and items allowable in RAP net worth but not allowable in GAAP net worth. Due to the accounting redefinition, the difference between the number of institutions that were insolvent by RAP accounting and the number that were insolvent by GAAP accounting grew steadily from 24 in 1981 to 363 in 1984.

In addition to altering RAP accounting for income and net worth, the Bank Board also reduced the minimum net-worth requirement from five to four percent in 1980 and then to three percent in 1982. When an institution's net worth falls below the minimum net-worth requirement, the Bank Board has substantially increased authority over the operation of the institution. Table 2 shows some of the implications of the relaxation of the net-worth requirement. In 1982, for example, 871 institutions representing about 26 percent of insured-institution's assets were at or below the minimum three percent net-worth requirement. Had the minimum net-worth requirement been five percent, 2,025 institutions representing 61 percent of insured institution's assets would have been at or below the requirement. At year-end 1984, 877 institutions representing 27 percent of total assets were at or below the three-percent requirement. If the five percent requirement had been in effect, 2,090 institutions representing 66 percent of total assets would have been at or below the requirement.

Due to two other regulatory provisions, furthermore, the minimum RAP net-worth requirement may be lower than three percent of total liabilities for some institutions. Until March 1985, when the Bank Board began phasing out the provisions, institutions could use techniques known as "five-year averaging" and "twenty-year phase in" to lower their regulatory net-worth requirement. With five-year averaging, an institution could average its past fiscal year's liabilities with the preceding four fiscal years and, thus,

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reduce the denominator in its net-worth to total liabilities calculation. With twenty-year phase in, institutions that had not reached their twentieth anniversary of insurance were permitted to multiply three percent of liabilities by a fraction, the numerator of which was the number of consecutive years of insurance and the denominator of which was twenty, in order to set their minimum net-worth requirement. Thus, for example, an institution that had insurance for only five years had a minimum net-worth requirement of (.03) (5/20)=.0075.

The deterioration of the financial condition of the thrift industry is reflected not only by the weakest thrift institutions, but also by the industry as a whole. As Table 3 shows, RAP and GAAP net worth for the industry were both 5.26 percent of assets in 1980 but declined to 3.86 and 2.87 percent, respectively, by 1984. Tangible net worth shows an even bigger decline to 0.39 percent in 1984 from 5.23 percent in 1980. Market-value net worth, however, significantly improved due to declining interest rates beginning in late 1982, but still remains negative. The improvement in market-value net worth has continued in 1985 due to the continuing fall in interest rates. Although the recent decline in interest rates represents a significant improvement over their movements in the early part of the decade, the thrift industry still has negative market-value net worth.

The large number of failures in 1982 was caused primarily by a maturity mismatch between assets and liabilities. Thrift institutions were holding relatively large amounts of long-term mortgages yielding rates of return that were not only fixed but fixed at rates below the rates paid on deposits. The decline in interest rates since then has, at least temporarily, reduced this particular problem for the thrift industry. Beginning in 1983, however, thrift institutions became increasingly hampered by poor-quality assets. The

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Table 3

TOTAL FEDERALLY INSURED
THRIFT-INSTITUTION NET WORTH: 1980-1984[a]

Year	RAP NW as a Percent of Total Assets	GAAP NW as a Percent of Total Assets	Tangible NW as a Percent of Total Assets	Market-Value NW as a Percent of Total Assets
1980	5.26	5.26	5.23	-12.47
1981	4.27	4.15	3.91	-17.32
1982	3.69	2.95	0.54	-12.03
1983	4.02	3.14	0.47	-5.64
1984	3.86	2.87	0.39	-2.74

[a]See Table 1 and Footnote 2 for an explanation of RAP and GAAP Net Worth. Tangible net worth is equal to GAAP net worth less goodwill and other intangible assets. The market value is based on yearly averages of estimated portfolio yields and market interest rates. The procedure employed is based upon a modification of Kane (forthcoming) which results in values of market-value net worth less negative than those reported by him. More detailed information pertaining to these calculations is available upon request.

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FSLIC considers two-thirds of its current cases to be primarily asset-quality problems. Interest-rate risk has for the moment abated and been replaced by credit risk as the major threat to thrift institutions.

To deal with these problems, the Bank Board and the FSLIC have taken several actions, including closing the most troubled institutions by either liquidating them or merging them with healthy institutions--frequently with financial assistance from the FSLIC. Liquidations have been rare, with only 25 in the first fifty years of the FSLIC. The reason for so few liquidations is that it has rarely been the least costly way of dealing with a failed institution. As Table 4 shows, in the 1980s the cost to the FSLIC of liquidating problem institutions was significantly greater than arranging an alternative solution, such as a merger with another institution. Despite this, there were 12 liquidations from 1980 through 1984.

Regardless of the method chosen for dealing with problem institutions, the resolution cost as a percent of assets of the failed institutions rose sharply in 1984, primarily because the cost of arranging mergers for those institutions with poor-quality assets was greater than the cost of arranging mergers for those institutions with interest-rate problems. The cost also rose because the geographic expansion of nonbank banks and other financial institutions eroded the benefits of the Bank Board's efforts, begun in 1981, to arrange mergers across state lines for troubled institutions. The expansion of nonbank banks reduced the value of acquiring a troubled institution in an interstate merger. The costs to the FSLIC of dealing with troubled institutions are expected to increase to the extent that nonbank banks and other financial institutions are permitted to expand in number and location.

Whether liquidating or arranging for mergers, the FSLIC is ultimately constrained by its reserves. As Table 5 shows, reserves of the FSLIC were

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Table 4

FSLIC-ASSISTED THRIFT-INSTITUTION FAILURES
LIQUIDATION COST VS. LEAST-EXPENSIVE SOLUTION COST:1980-1984[a]

Year	Present-Value Liquidation Cost (Thousands)	Present-Value Cost of Least-Expensive Solution (Thousands)	Ratio of Least-Expensive Solution Cost to Liquidation Cost	Least-Expensive Solution as a Percent of Total Assets of Failures Involving FSLIC Assistance
1980	$ 277,465	$ 166,644	0.60	11.4
1981	3,738,562	987,835	0.26	7.1
1982	6,908,002	1,127,077	0.16	4.0
1983	3,406,775	934,739	0.27	5.3
1984	1,543,473	849,842	0.55	14.7

[a]The present-value liquidation cost and present-value FSLIC-assistance cost are estimates that are calculated by the FSLIC in order to determine how to resolve each case. In cases where liquidation is less expensive than an alternative solution, the liquidation cost appears in the second column as well as the first column. These projections are made before funds are disbursed and will usually differ from the actual cost of whichever alternative is chosen.

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$6.46 billion in 1980 and declined to $5.96 billion in 1984. As Table 5 also shows, the reserves of the FSLIC, relative to total industry assets, fell to 0.61 percent in 1984 from 1.04 percent in 1980. Insured deposits exceeded $723 billion in 1984, while the reserves of the FSLIC were only $5.9 billion. Furthermore, Table 5 shows that the FSLIC's vulnerability to sudden movements in uninsured funds has increased since 1980. The $20 billion in uninsured deposits in 1980 represented 3.2 percent of total industry assets. The figure has grown to $61 billion representing 6.2 percent of total assets.

Uninsured deposits are a portion of large certificates of deposit referred to as Jumbo CDs, which also currently have an insured portion of $100,000. When depositors want to withdraw uninsured deposits, they tend to withdraw not only the uninsured portion of the Jumbo CDs but also the insured portion. As Table 6 shows, Jumbo CDs in the thrift industry in 1984 exceeded $113 billion or nearly 12 percent of total industry assets. A significant withdrawal of Jumbo CDs could cause an industry-wide drain on liquidity.

Table 6 also indicates that a substantial portion of industry deposits are in broker-originated deposits. Broker-originated deposits tend to be garnered in insured denominations, but tend to be more mobile than other insured deposits because the deposits are made primarily by institutional investors who by comparison with individuals constantly evaluate their positions. The level of broker-originated funds is about $43 billion or 4.4 percent of total industry assets. For the industry, the combined percentage of assets represented by Jumbo CDs and broker-originated funds is 16.1 percent. In the eleventh Federal Home Loan Bank Board District, which includes California, Jumbo CDs and broker-originated deposits represent nearly one-third of total assets.

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Table 5

RISK EXPOSURE TO THE FSLIC: 1980-1984

Year	Total Assets Insured Instit. (Millions) (1)	FSLIC-Insured Deposits (Millions) (2)	Uninsured Deposits in Insured Institutions (Millions) (3)	Regulatory Net Worth Insured Institutions (Millions) (4)	FSLIC Primary & Secondary Reserves (Millions) (5)	FSLIC Reserves as a Percent of Total Assets (6)=(5)/(1)	Regulatory Net Worth as a Percent of Assets (7)=(4)/(1)	FSLIC Reserves to Insured Savings (8)=(5)/(2)	Ratio of Insured to Total Deposits (9)=(2)/[(2)+(3)]
1980	618,466	483,030	20,126	32,436	6,462.3	1.04	5.24	1.34	96.00
1981	651,068	498,100	21,437	27,572	6,301.5	0.97	4.23	1.27	95.80
1982	692,663	534,120	26,342	25,386	6,330.8	0.91	3.66	1.19	95.30
1983	819,168	626,097	44,961	32,980	6,425.4	0.78	4.03	1.03	93.30
1984	978,514	723,516	61,208	37,927	5,961.5	0.61	3.88	0.82	92.20

Note: Maximum insurance coverage was as follows for the indicated dates:

1939-49: $ 5,000
1950-66: $10,000
1966-68: $15,000
1969-73: $ 20,000
1974-79: $100,000 for government accounts and $ 40,000 for all other accounts
1980-84: $100,000

Table 6

MAGNITUDE OF BROKER-ORIGINATED DEPOSITS (BOD) AND JUMBO CDS (JCD) IN FSLIC-INSURED INSTITUTIONS: 1980-1984

Year	BOD (Thousands)	BOD/TA (Percent)	JCD (Thousands)	JCD/TA (Percent)	BOD + JCD (Thousands)	(BOD+JCD)/TA (Percent)
1980	3,860,867	.6	39,667,320	6.6	43,528,187	7.2
1981	3,251,658	.5	47,483,749	7.4	50,735,407	7.9
1982	8,134,000	1.2	55,501,790	8.1	63,635,790	9.3
1983	29,711,673	3.7	80,051,685	9.8	109,763,358	13.5
1984	42,987,890	4.4	113,480,890	11.6	156,468,780	16.1

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The ratio of FSLIC reserves to insured deposits has risen above 2.0 percent in only two years since 1934 and has averaged 1.3 percent since 1974.[10] These figures indicate that FSLIC reserves are maintained at levels that are deemed sufficient to deal with normal levels of thrift-institution insolvencies, but certainly not an extraordinarily high and costly number of insolvencies. Thus, the federal government's insurance system must ultimately be backed by the Federal Reserve and the U.S. Treasury. This explains the passage of a Joint Concurrent Resolution in March 1982 placing the "full faith and credit" of the U.S. government behind the insurance fund's liabilities. (A concurrent resolution, however, is a nonbinding resolution that only expresses the "sense" of the Congress.) If future losses swamp the FSLIC fund and Congress does indeed provide funds, this will affect both monetary and fiscal policies and, thus, the federal deficit.

Deciding when to close an institution is difficult. An institution should generally be closed when the market value of its assets declines to the market value of its liabilities. It is possible, though unlikely, that none of the FSLIC-insured institutions with negative GAAP net worth satisfies this condition. The problem for the Bank Board and the FSLIC has been to determine whether an institution is insolvent based upon market values. This is difficult because the market value of an institution is the present discounted value of all future flows of revenue and costs. Thus, at a point in time, an institution can have negative net worth but have a positive market value. Such an institution is illiquid but not market-value insolvent.

Given this difficulty, the Bank Board has treated all currently GAAP-insolvent institutions (except those that are also RAP-insolvent) as illiquid but market-value solvent, or as insolvent but not severely enough to close

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given available financial and human resources. In addition to closing many institutions, the approach taken by the Bank Board and the FSLIC to the recent insolvencies has been to provide increased liquidity through advances, to implement accounting changes that have resulted in greater regulatory net worth, to lower overall net-worth requirements (until the decision on five-year averaging and twenty-year phase in), and most recently to institute new regulations aimed at reducing risk-taking activities by institutions. These and other recent regulatory changes are summarized in Table 7.

IV. Effect of Thrift Failures from 1980 to 1984 on Risk-Taking by FSLIC-Insured Institutions and Implications for the Reform of Federal Deposit Insurance

The growing level of insolvency among FSLIC-insured institutions has created a strong incentive for risk-taking. The source of the incentive for insolvent institutions to take risk is that deposit insurance creates a "heads I win, tails you lose" situation for insolvent institutions that are allowed to continue operating.[11] Financial gains accrue primarily to owners and managers if an insolvent institution takes a significant risk that succeeds, while the deposit insurer bears most of the cost if the risk fails. These perverse effects of deposit insurance also apply to depository institutions close to insolvency. Increased risk-taking provides possible improvement and resurrection in a relatively short period of time for the owners and managers of institutions nearing insolvency.

Since 1980, the incentive for insolvent or nearly insolvent institutions to take increased risk may have been increased by the impression among FSLIC-insured institutions that only a few of the more conspicuous outliers among insolvent institutions could be closed by the Bank Board due to the limited

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TABLE 7

SIGNIFICANT REGULATORY CHANGES

1980 Federal associations may establish branch offices and mobile facilities statewide (was within the home state and 100 miles of the home office). (January 1, 1980)

Depository Institutions Deregulation and Monetary Control Act (March 31, 1980)

FSLIC insurance coverage is $100,000 (was $40,000) per owner for insured accounts at insured institutions. (March 31, 1980)

FSLIC members may now borrow up to 50% of assets (was 50% of savings), although only 25% of assets may be pledged to secure outside borrowings; may accept more liabilities maturing within a three-month period; may otherwise borrow under more liberal rules than formerly. (May 30, 1980)

Florida Savings Association Act (July 1, 1980) expanded state-chartered thrift investment powers, as was done previously in Maine (1975) and Texas (1972).

FSLIC members may make real estate loans without regard to the geographic location of the security property; may make loans in excess of 90% of value on one-to four-family properties. (November 17, 1980)

Statutory Reserve Requirement reduced from 5 percent of insured accounts to 4 percent. Minimum Net Worth set at 4 percent of liabilities.

1981 Introduction of nationwide NOW accounts.

Institutions permitted to defer losses from the sale of assets with below-market yields.

Federal Home Loan Bank Board liberalized its regulations regarding the conversion of federally chartered institutions from mutual to stock type of organization (April 1981).

Adjustable-Rate Mortgages authorized (April 1981).

Federal association service corporations may now engage in a greatly enlarged list of activities without prior approval; may deal with a broader range of customers; and may borrow subject to fewer restrictions than formerly. (April 1981)

FHLB members may now borrow from their district Bank up to the lesser of (a) their legal maximum borrowing limit or (b) 50% of assets. (August 1981)

Qualifying Mutual Capital Certificates included as RAP net worth.

Income Capital Certificates introduced.

1982 Joint Concurrent Resolution (March 1982) passed, placing the "full faith and credit" of the U.S. Government behind the insurance fund's liabilities.

FSLIC members may exclude from liabilities in computing net worth certain contra-asset accounts, including loans in process, unearned discounts, and deferred fees and credits. (June 1982)

Garn-St Germain Depository Institutions Act (October 15, 1982).

Federal institutions may elect to be chartered as associations or savings banks; state savings banks may obtain federal mutual or stock charters while keeping FDIC insurance. (December 1982)

Money Market Deposit Account established (December 1982).

Net Worth Certificates, Qualifying Subordinated Debentures, Appraised Equity Capital included as RAP net worth.

Net Worth Requirement reduced to 3 percent of liabilities; Statutory Reserve Requirement reduced to 3 percent of insured accounts.

1983 California legislature passed the Nolan Bill (January 1, 1983), allowing state-chartered thrifts to broaden their investment activities.

Super NOW accounts introduced (January 1983).

FHLBs may make FSLIC-insured advances to institutions without customary credit evaluations. (February 1983)

State savings banks that convert to federal savings institution charters may continue to exercise the powers they had under the state charter. (March 1983)

FHLBs may make advances for terms of up to 20 (was 10) years. (September 1983)

Minimum capital requirements raised, other restrictions imposed on institutions seeking FSLIC insurance. (December 1983)

1984 Secondary Mortgage Market Enhancement Act

Federal associations may establish finance subsidiaries to issue securities for the parent institution. (July 1984)

Insured institutions must establish policies for the management of interest rate risk in the institutions' operations. (July 1984)

1985 Net Worth Regulation (March 21, 1985).

Direct Investment Regulation (March 21, 1985).

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Table 8

FAILURES OF FSLIC-INSURED INSTITUTIONS, INSOLVENT INSTITUTIONS, AND FSLIC RESERVES: 1980-1984

	Failures		Estimated GAAP Net Worth				FSLIC Reserves and Costs		
Year	Number of Failures	Assets of Failed Institutions ($ Millions)	Number of Institutions 0< NW/TL ≤.03	Assets of Institutions 0< NW/TL ≤.03 ($ Thousands)	Number of Institutions NW/TL ≤0	Assets of Institutions NW/TL ≤ 0 ($ Thousands)	FSLIC Primary & Secondary Reserves ($ Millions)	Ratio of FSLIC Reserves to Insured Liabilities	Estimated Present-Value Cost of New FSLIC-Assisted Case ($ Thousands)
1980	35	2,948	280	35,123,008	17	127,001	6,452	1.34	166,644
1981	81	15,057	653	126,666,356	65	17,303,469	6,302	1.27	987,835
1982	252	46,837	842	204,252,098	201	48,716,430	6,331	1.19	1,127,077
1983	101	15,909	883	242,657,975	287	78,906,404	6,425	1.03	934,736
1984	42	9,541	856	350,360,766	434	107,319,626	5,962	.82	849,842
Total	510	87,591							4,066,137

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resources of the FSLIC. This impression was almost certainly unavoidable as early as 1981 when the FSLIC was confronted with the abrupt and staggeringly large increase in insolvent and nearly insolvent institutions without any corresponding increase in the size of the FSLIC fund. Table 8 presents some of the data that may have conveyed the impression that the FSLIC could only handle the most severe cases. Between 1980 and 1981, the assets of institutions with GAAP net worth less than or equal to three percent rose by $108.7 billion and the FSLIC fund fell slightly from $6.46 to $6.30 billion. The ratio of FSLIC reserves to the assets of FSLIC-insured institutions with GAAP net worth less than or equal to three percent fell steadily from 18.3 percent in 1980 to 1.3 percent in 1984. Between 1981 and 1984, if even a small fraction of insolvent institutions had been closed, the FSLIC fund would have been depleted. For insolvent and nearly insolvent institutions aware of this fact, the incentive to take additional risk may have been enormous.

The impression that the Bank Board was unable to close all but the weakest institutions has been strengthened by the data on the FSLIC reserves, outlays, and the costs that the FSLIC was willing to incur from 1980 through 1984. As Table 8 shows, the FSLIC primary and secondary reserves were almost constant from 1980 through 1983, and though the coverage ratio of FSLIC reserves to insured liabilities steadily declined, the decline in each year was undramatic through 1983. As Table 8 also shows, the relatively constant reserve fund and coverage ratios were achieved by substantially reducing the present-value cost of new FSLIC cases after 1982 even though the number of insolvent institutions was growing.

The estimated present-value cost of new assistance cases, which is charged against FSLIC reserves, is the best measure of the burden that FSLIC takes on in a year. (These assistance cases stretch out over five to ten

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years, so the present-value costs are estimates by the FSLIC. Unexpected changes in interest rates and the disposability of assets, therefore, can significantly affect the actual cost.) A sharp increase in these costs occurred in 1981 when the FSLIC committed itself to an estimated $988 million to resolve 31 problem cases. This compares with $167 million to resolve 11 problem cases in 1980. The most costly year in the FSLIC's history was 1982, when the resolution of 77 problem cases was estimated to cost the insurer $1.1 billion in present-value terms. In the two years following 1982, the cost of new FSLIC-assisted cases declined to $935 million in 1983 and $850 million in 1984. As these numbers emerged, the rapidly growing number of insolvent and nearly insolvent institutions may have inferred that the FSLIC's policy was to manage costs in order to maintain the FSLIC reserve fund at a relatively constant level. By 1984, when both the reserve fund and the coverage ratio dropped sharply, it became apparent that the cost of resolving failures was great enough that the FSLIC could no longer maintain the level of fund reserves or coverage level even with fewer failures that year.

As already discussed, moreover, RAP net worth began to deviate from GAAP net worth in 1981. Due to the accounting redefinition, the difference between the number of institutions that were insolvent by RAP accounting and the number that were insolvent by GAAP accounting grew steadily from 24 in 1981 to 363 in 1984. The altered RAP net-worth calculation was another strong indication that the Bank Board and the FSLIC could not close all insolvent institutions.

Between 1981 and 1984, proposals to reform federal deposit insurance by adopting risk-sensitive deposit insurance premiums became more frequent and included endorsements by the Bank Board and the FDIC in reports to Congress

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in 1983.[12] A risk-sensitive premium applied to all FSLIC-insured institutions, however, would raise the premiums paid by insolvent and nearly insolvent institutions. But, as already noted, insolvency itself creates an incentive for these institutions to take greater risk. This incentive has been augmented by the fact that with its current reserves the FSLIC cannot close what may amount to hundreds of insolvent institutions. A risk-sensitive premium that would raise premium costs for these institutions would, therefore, simply create a further incentive to take greater risk in order to recover the additional premium costs.[13] By comparison with a fixed-rate premium, a risk-sensitive premium imposed when the insurer cannot close insolvent institutions may tend to increase risk-taking by insolvent or nearly insolvent institutions because with the fixed-rate premium the institutions do not need to recover additional premium costs.

The inability to close insolvent institutions has important implications for two other often-suggested methods for reducing risky activities of insured-deposit institutions: (1) decreasing the level of deposits covered by deposit insurance, and (2) greater disclosure of the condition of institutions. Decreasing the coverage level, thereby putting additional depositors at greater risk should the insurer close an institution, increases uninsured depositor scrutiny of depository institutions' conduct and performance. With additional uninsured depositor vigilance, uninsured depositors, among other actions, tend to withdraw funds in reaction to diminished performance.

If, however, the insurer is or is perceived to be reluctant to close insolvent institutions, and if little capital and income are at risk, the decreased coverage will tend to increase risk-taking. Although newly uninsured depositors still respond to any deteriorating performance associated with increased risk, the institution--at least for a while--has the

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opportunity to attract new insured and uninsured depositors or hold old ones with higher interest rates. In order to pay higher rates, greater risk needs to be taken. Thus, when the insurer is unable to close insolvent institutions, a decreased coverage level may tend to stimulate risk-taking.

Greater disclosure may tend to speed the reaction of depositors and increase the number of depositors who would react to a decline in condition. Increasing the number of uninsured depositors and providing them with better information when the number of insolvent and nearly insolvent FSLIC-insured institutions is as large as it is today, may increase the probability of widespread runs. Depositors who for the first time would be in jeopardy of losing funds may tend to be highly skittish. Depositors who had been uninsured before the coverage level was reduced and who expected that the insurer would make uninsured depositors whole if an institution failed would reassess their expectation as the number of uninsured depositors grew. As a result, they too might become more prone to withdraw funds.

Risk-sensitive premiums, lower coverage levels, and increased disclosure may also tend to increase risk-taking among solvent institutions. Some insolvent institutions taking greater risk may tend to grow, and in order to grow will offer higher interest rates on liabilities. The most aggressively growing insolvent depository institutions may then determine the level of interest rates paid, and assuming that the supply curve of funds is upward sloping, interest rates on insured deposits may rise to the level necessary to sustain the institution's desired rate of growth. Competing solvent institutions may then react to a shrinking market share of deposits. If the competitors wish to maintain their market share, they will meet the interest rate paid by the insolvent institutions. In order to maintain expected profitability, both the insolvent and solvent institutions will select assets

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with greater expected return and, simultaneously, greater risk. The ceiling on the level of risk taken by the institutions will be set by insolvent institutions and that risk level will be governed by the risk-return preference of the insolvent institution and the insolvent institution's perception of how much risk can be taken before the insurer will close an institution.

V. Conclusions and Unresolved Policy Issues

Although there has recently been an unprecedented number of thrift-institution failures, the even larger number of institutions with negative and extremely low positive levels of net worth indicates that the number of future failures is likely to be large.[14] The FSLIC's reserves, however, are at an extremely low level. The major short-term issue is, therefore, how to handle with limited reserves the large number of insolvent institutions. To the extent that the present value of an institution's assets (tangible and intangible) and liabilities are zero, they should generally be closed. Although the number of such insolvencies may be so large that the FSLIC fund, even with increased industry assessments, is insufficient to handle the problem, not closing these institutions most likely increases the eventual cost to the FSLIC as the institutions try to overcome their problems through riskier activities. Delay itself is therefore costly.

One option suggested by the widespread criticism of RAP accounting is to return to the rules for closure that existed in 1980. If that were done, 434 FSLIC-insured institutions with GAAP net worth to total liabilities less than or equal to zero could be closed. In order to do this, the Bank Board would need to eliminate the changes in Regulatory Accounting Principles that, beginning in 1981, made RAP net worth deviate from GAAP net worth. The Bank Board would also need to raise the regulatory minimum net-worth standard from three percent to the five percent that prevailed in the beginning of 1980.

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This would mean that the number of institutions that would be supervisory cases would rise from about 800 to more than 1600. These changes would mean that institutions representing ten percent of total assets of FSLIC-insured institutions could be closed and institutions representing 68 percent of total assets would be supervisory cases. Based on the least-cost method of resolving FSLIC cases in 1984 this could entail an expenditure of $15.8 billion if all 434 GAAP-insolvent institutions were closed.[15] This potential cost not only underscores the fact that the fund is not designed to cope with an abnormal number of failures, but also that thrift-institution failures have important implications for fiscal and monetary policy and the U.S. deficit.

What regulatory changes are needed in the meantime to limit any "excessive" risk-taking by the troubled institutions, including the possibility of switching from a flat-rate insurance premium to a risk-sensitive one, are also important issues. In the short run, the imposition of a risk-sensitive premium, reducing the coverage level, and increasing disclosure may offer little in terms of reducing overall risk-taking. Moreover, in the face of enormous incentives for nearly insolvent and insolvent institutions to take risks that are excessive from the insurer's view, regulatory changes such as the recent regulation limiting direct investment will be necessary but their overall effectiveness in reducing risk-taking may prove disappointing.

The major long-term issue is whether thrift institutions should be kept separate from commercial banks. Recent technological change, financial innovation, and deregulation suggest that the economic distinctions between the institutions will continue to blur. Competition among thrifts, commercial banks, and other providers of financial services also suggests that the distinctions will be difficult to maintain without significant regulatory action.[16] These forces indicate that the consolidation of function and regulation are issues that will become increasingly important and intense.[17] Simultaneously, the source and amount of home ownership financing will become more of an issue.

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FOOTNOTES

1. An institution is defined to be a failure if liquidated by the FSLIC, merged by the FSLIC with financial assistance, or merged as the result of supervisory action taken by the Federal Home Loan Bank Board.

2. These figures are based upon Generally Accepted Accounting Principles (GAAP). Figures based upon Regulatory Accounting Principles (RAP) are somewhat smaller but nonetheless consistent with the seriousness of the current problem. RAP net worth includes the following items:
   (1) Preferred Stock;
   (2) Permanent, Reserve, or Guaranty Stock;
   (3) Paid-In Surplus;
   (4) Reserves;
   (5) Undivided Profits (Retained Earnings);
   (6) Net Undistributed Income;
   (7) Qualifying Mutual Capital Certificates;
   (8) Income Capital Certificates;
   (9) Net Worth Certificates;
   (10) Qualifying Subordinated Debentures; and
   (11) Appraised Equity Capital.

   These items are reported on the Bank Board's Semiannual Financial Report through 1983 and on the Quarterly Financial Report since 1983. GAAP net worth excluded items (7)-(11) through 1983. Since 1983, Income Capital Certificates have been included in GAAP net worth. GAAP net worth subtracts (adds) deferred net losses (gains) on assets sold. For data on the magnitude of the components that differentiate GAAP from RAP net worth, see Table A-7 in the Appendix.

3. In 1984, the fund declined about seven percent from the 1983 level. Smaller declines occurred in 1950 and 1981.

4. For other recent discussions of many of these same issues, see Kane (forthcoming), Balderston (1985), Merrick and Saunders (1985), Horvitz (1983), Greenbaum (1985), and Carron (1982 and 1983).

5. See Milton Friedman and Anna J. Schwartz, A Monetary History of the United States, 1867-1960, (Princeton: Princeton University Press, 1963).

6. For a study of the implications of deposit insurance and contemporary bank and thrift failures, primarily large-institution failures, see Kaufman (1985). For a more general discussion of the role of the lender of last resort in dealing with financial crises, see Barth and Keleher (1984).

7. For a more detailed description of this phenomenon, especially in the context of the current difficulties faced by thrift institutions, see Brumbaugh and Hemel (1984). Also, see Kareken (1983), Buser, Chen and Kane (1981), Short and O'Driscoll (1983), Clair (1984), Benston (1984), Wall (1984), Keeton (1984), and Flannery and Protopapadakis (1984).

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8. A 1970 Amendment to the Bank Holding Company Act of 1956 defines a bank as an institution that both accepts demand deposits and makes commercial loans. A nonbank performs only one of these services.

9. See the tables in the appendix for more detailed historical data on thrift-institution failures and the FSLIC losses due to the failures. For purposes of comparison, selected commercial bank data are also provided.

10. See Table A-4 in the appendix.

11. For other descriptions of this phenomenon, see Horvitz (December 1983) and Guttentag and Herring (1982).

12. See Federal Home Loan Bank Board (1983) and Federal Deposit Insurance Corporation (1983).

13. Even though a risk-sensitive premium would not reduce overall risk-taking among insolvent and nearly insolvent institutions, it could serve other purposes. For example, if specified activities generated higher premiums, those activities would be discouraged. Thus, if Congress grants the Bank Board's request for authority to charge higher premiums for state-chartered FSLIC-insured institutions engaging in activities not allowed federally chartered institutions, the higher premiums would tend to discourage those activities.

14. For an econometric analysis of the determinants of failure for federally insured thrift institutions, see Barth, Brumbaugh, Sauerhaft, and Wang (1985).

15. This estimate was calculated by multiplying the 1984 figure for the "least expensive solution as a percent of total assets of failures involving FSLIC assistance" from Table 4 by the 1984 figure for "assets of institutions with GAAP net worth to total liabilities ≤ 0" from Table 8. Thus, 14.7 percent of $107.3 billion in assets equals $15.8 billion.

16. For a discussion of increasing competition in the financial services industry, see Rosenblum, Siegal, and Pavel (1983).

17. For an argument in favor of consolidation, see Carron (1984).

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APPENDIX

The tables in this appendix present a historical perspective of thrift-institution failures and the resulting cost to the FSLIC as well as some related data for commercial banks.

Table A-1

FSLIC-INSURED FAILURES: A HISTORICAL PERSPECTIVE*

Year	Number of Failures (1)	Number of Insured Institutions (2)	Number of Insured Accts. of Failed Institutions (3)	Number of Insured Accts. for all Institutions (Thousands) (4)	Assets of Failed Institutions (Thousands) (5)	Assets of all Institutions (Millions) (6)	Percent of Institutions That Failed (7) = (1)/(2)	Percent of Insured Accts. Held by Failed Institutions (8) = (3)/(4)	Percent of Assets Held by Failed Institutions (9) = (5)/(6)
1934	0	541	0	201	0	150	0	0	0
1935	1	1,117	2	660	13	711	0.09	0	0
1936	0	1,575	0	1,024	0	1,281	0	0	0
1937	0	1,664	0	1,409	0	1,758	0	0	0
1938	4	2,088	1,451	1,833	944	2,127	0.19	0.08	0.04
1939	6	2,199	21,360	2,236	22,143	2,511	0.36	0.96	0.88
1940	7	2,277	9,080	2,562	8,786	2,935	0.31	0.36	0.3
1941	13	2,343	25,160	2,975	28,986	3,353	0.55	0.85	0.86
1942	3	2,388	7,173	3,218	6,434	3,643	0.13	0.22	0.18
1943	1	2,407	180	3,604	636	4,123	0.04	0.01	0.02
1944	1	2,466	392	3,830	368	4,566	0.04	0.01	0.01
1945	0	2,475	0	4,277	0	6,123	0	0	0
1946	0	2,485	0	4,644	0	7,294	0	0	0
1947	1	2,530	831	5,176	1,862	8,529	0.04	0.02	0.02
1948	0	2,616	0	6,122	0	9,715	0	0	0
1949	1	2,756	2,886	7,095	4,884	11,278	0.04	0.04	0.04
1950	0	2,865	0	8,111	0	13,681	0	0	0
1951	0	3,020	0	9,354	0	16,354	0	0	0
1952	0	3,172	0	10,806	0	19,066	0	0	0
1953	0	3,304	0	12,323	0	21,983	0	0	0
1954	3	3,413	1,560	13,773	1,569	28,367	0.09	0.01	0.01
1955	0	3,544	0	15,427	0	34,198	0	0	0
1956	1	3,666	9,106	17,764	22,470	39,338	0.03	0.05	0.06
1957	0	3,772	0	19,788	0	44,469	0	0	0
1958	0	3,865	0	21,832	0	51,211	0	0	0
1959	0	3,979	0	24,304	0	59,883	0	0	0
1960	7	4,098	29,815	27,129	110,361	67,630	0.05	0.11	0.16
1961	1	4,231	3,987	29,815	10,610	77,984	0.02	0.01	0.01
1962	1	4,332	703	32,243	2,780	88,545	0.02	0	0
1963	4	4,419	33,082	34,197	79,564	103,154	0.09	0.10	0.08
1964	4	4,603	36,714	36,507	93,936	114,062	0.09	0.07	0.08
1965	5	4,709	41,409	38,266	160,792	124,576	0.11	0.11	0.15
1966	10	4,840	108,332	40,582	863,790	139,045	0.22	0.47	0.63
1967	6	4,967	28,595	42,225	97,540	138,488	0.13	0.06	0.04
1968	7	4,970	75,884	43,547	308,314	147,736	0.16	0.17	0.21
1969	3	4,908	9,231	45,192	16,942	156,788	0.07	0.08	0.01
1970	10	4,815	257,729	46,537	1,213,029	170,645	0.23	0.58	0.71
1971	7	4,771	49,771	48,325	167,053	199,184	0.16	0.10	0.09
1972	3	4,191	9,916	52,959	26,335	226,340	0.07	0.02	0.01
1973	6	4,163	13,692	57,514	47,763	264,797	0.12	0.02	0.02
1974	2	4,141	41,752	61,797	156,880	288,223	0.05	0.07	0.05
1975	2	4,098	29,831	67,385	119,380	330,259	0.05	0.04	0.04
1976	6	4,044	58,800	73,542	148,887	383,172	0.15	0.08	0.04
1977	3	4,005	64,902	79,306	187,052	440,988	0.07	0.07	0.04
1978	2	4,019	6,773	84,772	23,886	513,330	0.05	0.01	0
1979	3	4,009	130,459	88,182	579,921	568,167	0.07	0.14	0.10
1980	26	4,002	163,782	92,189	2,947,077	610,466	0.65	0.18	0.48
1981	81	3,779	1,180,233	98,740	15,557,057	661,088	2.14	1.20	2.35
1982	252	3,343	2,817,747	99,905	46,835,869	892,663	7.54	2.85	5.76
1983	101	3,080	1,365,031	103,214	15,930,495	819,188	3.28	1.33	1.96
1984*	42	3,147	1,439,712	108,738	9,543,257	970,514	1.33	1.32	0.98

*"Failure" is defined to be a case requiring supervisory action or FSLIC assistance. Due to lack of data, failure data include only FSLIC-assisted cases prior to 1980, and hence are not directly comparable to subsequent years. Insured accounts data (columns 3 and 8) include only FSLIC-assisted cases for all years.

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TABLE A-2

COMMERCIAL BANK FAILURE: A HISTORICAL PERSPECTIVE

Year	Number of FDIC-Insured Failures (1)	Number of Banks* (2)	Number of Insured Accts. of Failed Banks** (3)	Assets of Failed Banks (thousands) (4)	Assets of all Banks (millions) (5)	Percent of Banks that Failed (6) = (1)/(2)	Percent of Assets Held by Failed Banks (7) = (4)/(5)
1934	9	15,348	15,767	2,661	44,978	0.06	0.01
1935	26	15,453	44,856	17,242	48,905	0.17	0.04
1936	69	15,329	89,018	31,941	55,572	0.45	0.06
1937	77	15,084	130,387	40,370	56,907	0.51	0.07
1938	74	14,857	200,961	69,513	56,185	0.50	0.12
1939	60	14,657	382,718	181,514	61,422	0.41	0.30
1940	43	14,534	256,361	163,898	67,804	0.30	0.24
1941	15	14,434	73,005	34,804	75,356	0.10	0.05
1942	20	14,353	60,688	22,254	80,276	0.14	0.03
1943	5	14,197	27,371	14,056	104,322	0.04	0.01
1944	2	14,138	5,657	2,098	125,031	0.01	0
1945	1	14,126	12,483	6,382	146,245	0.01	0
1946	1	14,152	1,383	351	153,507	0.01	0
1947	5	14,162	10,637	6,798	146,974	0.04	0
1948	3	14,189	18,540	10,380	148,799	0.02	0.01
1949	5	14,151	5,671	4,886	149,705	0.04	0
1950	4	14,146	6,366	4,005	156,914	0.03	0
1951	2	14,107	5,776	3,050	165,303	0.01	0
1952	3	14,089	6,752	2,388	177,417	0.02	0
1953	4	14,035	24,489	18,811	181,427	0.03	0.01
1954	2	13,936	1,811	1,138	190,981	0.01	0
1955	6	13,780	17,790	11,985	199,244	0.04	0.01
1956	2	13,640	15,197	12,914	219,000	0.01	0.01
1957	2	13,595	2,108	1,253	224,000	0.01	0
1958	4	13,591	9,587	8,905	240,000	0.03	0
1959	3	13,474	3,893	2,858	245,415	0.02	0
1960	1	13,472	11,171	7,506	258,389	0.01	0
1961	5	13,432	8,301	9,820	279,503	0.04	0
1962	1	13,429	N/A	N/A	298,196	0.01	N/A
1963	2	13,570	36,433	26,179	314,066	0.01	0.01
1964	7	13,761	19,934	25,849	348,433	0.05	0.01
1965	5	13,804	15,817	58,750	378,899	0.04	0.02
1966	7	13,767	95,424	157,647	406,515	0.05	0.03
1967	4	13,722	4,729	11,993	454,803	0.03	0
1968	3	13,679	12,880	25,154	504,637	0.02	0
1969	9	13,651	27,374	43,572	535,680	0.07	0.01
1970	7	13,688	31,433	62,147	577,047	0.05	0.01
1971	6	13,784	71,950	196,520	640,935	0.04	0.03
1972	1	13,928	23,666	22,054	730,592	0.01	0
1973	6	14,172	349,699	1,309,695	835,730	0.04	0.16
1974	4	14,657	704,283	3,822,596	980,001	0.03	0.42
1975	13	14,632	110,367	419,950	965,198	0.09	0.04
1976	16	14,573	340,731	1,039,293	1,030,811	0.11	0.10
1977	6	14,705	96,548	232,612	1,166,145	0.04	0.02
1978	7	14,712	364,184	994,035	1,253,100	0.05	0.08
1979	10	14,708	42,009	132,998	1,362,200	0.07	0.01
1980	10	14,836	78,261	236,164	1,537,300	0.07	0.02
1981	10	14,900	693,308	4,869,060	1,651,800	0.07	0.29
1982	42	14,963	1,964,368	11,632,415	1,820,000	0.28	0.64
1983	48	15,047	934,023	7,206,923	2,027,300	0.32	0.36
1984	79	15,101	N/A	3,276,411	N/A	0.52	N/A

*Commercial Banks

**Includes only the accounts of those failures requiring FDIC disbursement.
Thus 8 banks that appear in column 1 from 1934 through 1980 are excluded from column 3.

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Table A-3

A COMPARISON OF FAILURE RATES FOR THRIFTS, COMMERCIAL BANKS AND BUSINESSES

Year	Failures (Business) Per 1,000	Failures (Thrift) Per 1,000*	Failures (Commercial Banks) Per 1,000
1934	6.10	0	0.60
1935	6.20	0.90	1.70
1936	4.80	0	4.50
1937	4.60	0	5.10
1938	6.10	1.90	5.00
1939	7.00	3.80	4.10
1940	6.30	3.10	3.00
1941	5.50	5.50	1.00
1942	4.50	1.30	1.40
1943	1.60	0.40	0.40
1944	0.70	0.40	0.10
1945	0.40	0	0.10
1946	0.50	0	0.10
1947	1.40	0.40	0.40
1948	2.00	0	0.20
1949	3.40	0.40	0.40
1950	3.40	0	0.30
1951	3.10	0	0.10
1952	2.90	0	0.20
1953	3.30	0	0.30
1954	4.20	0.90	0.10
1955	4.20	0	0.40
1956	4.80	0.30	0.10
1957	5.20	0	0.10
1958	5.00	0	0.30
1959	5.20	0	0.20
1960	5.70	0.50	0.10
1961	6.40	0.20	0.40
1962	6.10	0.20	0.10
1963	5.60	0.90	0.10
1964	5.30	0.90	0.50
1965	5.30	1.10	0.40
1966	5.20	2.20	0.50
1967	4.90	1.30	0.30
1968	3.90	1.60	0.20
1969	3.70	0.70	0.70
1970	4.40	2.30	0.50
1971	4.20	1.60	0.40
1972	3.80	0.70	0.10
1973	3.60	1.20	0.40
1974	3.80	0.50	0.30
1975	4.30	0.50	0.90
1976	3.50	1.50	1.10
1977	2.80	0.70	0.40
1978	2.40	0.50	0.50
1979	2.80	0.70	0.70
1980	4.20	8.70	0.70
1981	6.10	21.40	0.70
1982	8.80	75.40	2.80
1983	11.00	33.20	3.20
1984	9.60	13.30	5.20

*Data on unassisted thrift failures was unavailable prior to 1980. Since 1980 the data reflected both unassisted supervisory cases and FSLIC-assisted cases.

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Table A-4

RISK EXPOSURE TO THE FSLIC

Year	Total Assets Insured Instit. (billions) (1)	FSLIC-Insured Deposits (billions) (2)	Uninsured Deposits in Insured Institutions (billions) (3)	Regulatory Net Worth Insured Institutions (billions) (4)	FSLIC Primary & Secondary Reserves (billions) (5)	Regulatory Net Worth as Percent of Assets (6)=(4)/(1)	FSLIC Reserves to Insured Savings (7)=(5)/(2)	Ratio of Insured to Total Deposits (8)=(2)/[(2)+(3)]	Net Income as a Percent of Assets (9)
1934	130	N/A	N/A	N/A	1.6	N/A	N/A	N/A	N/A
1935	711	N/A	N/A	N/A	1.9	N/A	N/A	N/A	N/A
1936	1,281	N/A	N/A	78	6.0	6.09	N/A	N/A	N/A
1937	1,788	N/A	N/A	103	10.6	5.86	N/A	N/A	N/A
1938	2,127	N/A	N/A	138	15.0	6.02	N/A	N/A	N/A
1939	2,521	1,716	139	145	20.7	5.77	1.21	92.51	N/A
1940	2,565	2,002	125	152	20.4	5.94	1.27	94.14	N/A
1941	3,331	2,495	154	203	21.3	6.05	1.28	94.07	N/A
1942	3,643	2,806	147	205	20.7	7.27	1.25	95.74	N/A
1943	5,573	3,457	154	337	44.6	7.38	1.31	95.60	N/A
1944	4,999	4,137	182	361	53.3	7.03	1.29	95.79	N/A
1945	6,123	4,941	220	432	67.2	6.73	1.36	94.82	N/A
1946	7,294	5,831	273	488	72.6	6.70	1.25	93.97	1.20
1947	8,588	6,712	405	578	84.5	6.73	1.26	93.57	1.04
1948	9,715	7,736	519	674	97.8	6.96	1.27	93.47	1.02
1949	11,278	9,064	636	804	113.1	7.13	1.25	93.44	1.04
1950	13,961	11,158	816	995	93.6	7.19	0.84	93.10	1.19
1951	16,324	13,313	330	1,189	109.1	7.38	0.80	97.58	1.10
1952	19,496	16,271	463	1,402	130.5	7.13	0.74	97.24	1.08
1953	23,193	19,557	605	1,643	137.7	6.96	0.70	96.72	1.02
1954	28,357	23,746	783	1,926	158.5	6.79	0.67	96.81	1.06
1955	34,386	28,145	1,006	2,231	183.4	6.73	0.65	96.25	1.10
1956	38,118	32,075	1,277	2,697	212.2	6.86	0.66	96.26	1.02
1957	44,489	37,334	1,439	3,109	246.9	6.69	0.66	96.29	0.95
1958	51,331	42,722	1,548	3,556	284.2	7.01	0.67	95.64	0.97
1959	59,583	48,797	2,313	4,142	335.3	6.96	0.67	95.38	0.97
1960	67,430	55,828	2,854	4,718	380.9	7.02	0.68	95.13	0.92
1961	77,994	64,139	3,173	5,463	440.9	7.01	0.69	95.29	0.98
1962	88,545	72,535	4,338	6,305	478.0	7.04	0.93	94.52	0.98
1963	103,154	82,898	5,478	6,987	544.7	6.77	1.15	93.74	0.78
1964	114,652	92,870	4,991	7,885	1,248.9	6.70	1.34	94.92	0.72
1965	124,576	99,032	7,861	8,333	1,337.1	6.69	1.35	93.26	0.67
1966	129,846	102,964	8,817	8,814	1,284.8	6.79	1.25	97.43	0.59
1967	138,489	114,562	3,622	9,489	2,080.1	6.85	1.76	96.98	0.67
1968	147,735	123,184	4,060	10,251	2,409.4	6.94	1.96	96.84	0.82
1969	156,780	128,883	2,112	11,149	2,801.3	7.11	2.17	98.39	0.88
1970	170,645	137,146	4,557	11,910	2,982.8	6.98	2.12	96.78	0.57
1971	189,984	163,480	5,581	13,086	2,986.9	6.91	1.83	96.69	0.71
1972	235,349	193,942	10,088	14,707	3,142.4	6.27	1.66	95.01	0.77
1973	264,797	208,979	10,914	16,559	3,453.5	6.25	1.64	95.05	0.76
1974	288,223	232,336	4,263	17,868	3,778.4	6.20	1.63	98.16	0.54
1975	330,259	271,451	7,323	19,175	4,119.6	5.81	1.52	97.37	0.67
1976	383,172	314,700	11,514	21,372	4,481.1	5.58	1.41	96.48	0.63
1977	449,188	362,864	15,566	24,525	4,872.8	5.46	1.34	95.78	0.77
1978	513,350	402,541	19,053	28,281	5,339.2	5.51	1.32	95.35	0.82
1979	588,937	430,294	20,400	31,749	5,847.8	5.39	1.35	93.40	0.97
1980	660,466	463,030	26,126	37,435	6,462.3	5.24	1.34	95.00	-0.14
1981	661,089	488,100	21,897	27,972	6,381.5	4.23	1.27	95.60	-0.73
1982	692,663	534,120	25,342	25,386	6,130.8	3.66	1.19	95.30	-0.66
1983	819,388	615,097	44,961	32,980	6,425.4	4.03	1.09	93.30	0.27
1984	976,514	723,516	61,288	37,907	5,961.5	3.88	0.82	92.30	0.39

Note: Maximum insurance coverage was as follows for the indicated dates:

1934-43: $ 5,000
1944-65: $10,000
1966-68: $15,000
1969-73: $ 20,000
1974-79: $100,000 for government accounts and
$ 40,000 for all other accounts
1980-84: $100,000

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TABLE A-6

FSLIC LOSSES

Year	Outlays to date for Insti. Defaulting Specified Year (thousands) (1)	Present Value Projected Future Loss for Defaults, Specified Year (2)	Total Present Value Loss to FSLIC from Insti. Defaults in Given Year (thousands) (3)=(1)+(2)	Total FSLIC-Insured Deposits (millions) (4)	Loss Per $100 of Insured Deposits** (5)=(3)/(4)	Premium Per $100 Insured Deposits (6)	Excess of Premium Over Insurance Loss Per $100 Insured Deposits** (7)=(6)-(5)
1934	0	0	0	N/A	N/A	.250	N/A
1935	2	0	2	N/A	N/A	.125	N/A
1936	0	0	0	N/A	N/A	.125	N/A
1937	0	0	0	N/A	N/A	.125	N/A
1938	124	0	124	N/A	N/A	.125	N/A
1939	1,791	0	1,791	1,716	.104	.125	.021
1940	642	0	642	2,082	.031	.125	.094
1941	2,333	0	2,333	2,465	.094	.125	.031
1942	238	0	238	2,655	.008	.125	.117
1943	60	0	60	3,417	.002	.125	.123
1944	38	0	38	4,137	.001	.125	.124
1945	0	0	0	4,941	0	.125	0
1946	0	0	0	5,811	0	.125	0
1947	0	0	0	6,712	0	.125	0
1948	0	0	0	7,716	0	.125	0
1949	-41	0	-41	9,064	0	.125	0
1950	0	0	0	11,159	0	.083	0
1951	0	0	0	13,323	0	.083	0
1952	0	0	0	16,271	0	.083	0
1953	0	0	0	19,387	0	.083	0
1954	0	0	0	23,746	0	.083	0
1955	0	0	0	28,145	0	.083	0
1956	-3	0	-3	32,875	0	.083	0
1957	0	0	0	37,234	0	.083	0
1958	0	0	0	42,722	0	.083	0
1959	0	0	0	48,797	0	.083	0
1960	3,477	0	3,477	55,808	.006	.083	.077
1961	189	0	189	64,139	0	.083	0
1962	171	0	171	72,536	0	.083*	0
1963	17,431	0	17,431	82,048	.021	.083*	.062
1964	18,852	0	18,852	92,870	.020	.083*	.063
1965	15,935	0	15,935	99,032	.016	.083*	.067
1966	19,236	0	19,236	105,955	.018	.083*	.065
1967	4,037	0	4,037	116,592	.004	.083*	.079
1968	22,561	0	22,561	123,184	.018	.083*	.065
1969	462	0	462	128,883	0	.083*	0
1970	53,109	N/A	N/A	137,146	.039	.083*	.044
1971	18,944	0	18,944	163,460	.012	.083*	.071
1972	722	0	722	190,942	0	.083*	0
1973	3,782	0	3,782	209,572	.018	.083*	.065
1974	8,720	0	8,720	232,136	.004	.083	.079
1975	6,311	0	6,311	271,451	.002	.083	.081
1976	9,599	N/A	N/A	316,700	.003	.083	.080
1977	21,727	N/A	N/A	362,816	.006	.083	.077
1978	4,320	0	4,320	402,541	.001	.083	.082
1979	71,561	N/A	N/A	430,294	.017	.083	.066
1980	1,146,000	N/A	N/A	483,030	.237	.083	-.154
1981	1,447,742	N/A	N/A	498,100	.291	.083	-.208
1982	384,864	N/A	N/A	534,120	.072	.083	.011
1983	637,910	N/A	N/A	626,087	.102	.083	-.019
1984	789,992	N/A	N/A	713,807	.107	.083	-.024

** Preliminary figure (exclude present value projected future loss, column 2)
* 1962-1973 Annual prepayments into the secondary reserve were intermittently required during this period.

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TABLE A-7

HISTORICAL COMPARISON FOR ALL FSIC-INSURED INSTITUTIONS OF NET WORTH DEFINED BY REGULATORY ACCOUNTING PRINCIPLES (RAP) AND GENERALLY ACCEPTED ACCOUNTING PRINCIPLES(GAAP)

	Items Included in RAP But Not in Estimated GAAP Net Worth				Items Deducted (Added) When Computing Estimated GAAP But Not RAP Net Worth	Amount by Which RAP Net Worth Exceeds Estimated GAAP Net Worth	
Year	Qualifying Mutual Capital Certificates ($ Thousands)	Income Capital and Net Worth Certificates[a] ($ Thousands)	Qualifying Subordinated Debentures ($ Thousands)	Appraised Equity Capital ($ Thousands)	Deferred Losses (Gains) on Assets Sold ($ Thousands)	Total of All Previous Columns ($ Thousands)	Total Differential as Percent of Total Assets
1980	0	0	0	0	5,784	5,784	0.001
1981	39,560	0	0	0	752,509	792,069	0.122
1982	59,626	472,260	225,624	674,515	3,637,998	5,070,023	0.739
1983	20,252	1,005,628	333,419	1,236,808	4,556,874	7,152,981	0.878
1984[b]	109,794	192,983	1,046,798	1,474,967	6,387,671	9,212,213	0.942

[a] In 1984, accounting procedures were changed such that income capital certificates were included in GAAP net worth, where previously they had been included in net worth only under RAP accounting. Hence, the 1984 figure for this category only reflects net worth certificates.

[b] All 1984 data are preliminary figures.

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Table A-6

PROFITABILITY OF FSLIC-INSURED THRIFT INSTITUTIONS

Year	Net Income[a] (millions)	Net Operating Income[b] (millions)	Net Nonoperating Income[c] (millions)	Income Taxes (millions)	Regulatory Net Worth (millions)	Net Income as Percent of Previous Year's Regulatory Net Worth
1980	$ 781	$ 790	$ 398	$ 407	$32,436	2.5
1981	-4,631	-7,114	964	-1,519	27,572	-14.3
1982	-4,142	-8,761	3,041	-1,578	25,386	-15.0
1983	1,945	- 46	2,567	576	32,980	7.7
1984	1,165	1,044	911	788	37,927	3.5

[a] Net income is net operating income plus net nonoperating income less income taxes. Due to rounding, the components may not sum exactly to net income.

[b] Net operating income is operating income less operating expenses and interest charges on liabilities.

[c] Net nonoperating income is nonoperating income less nonoperating expenses where nonoperating income comes primarily from profits on the sale of assets and nonoperating expenses comes primarily from losses from the sale of assets.

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Senator PROXMIRE. Thank you.

Mr. GRAY. I just wanted to say the following. You're absolutely right that in absolute terms, under a worst case scenario, if you had to do this tomorrow—for that matter, if you had to liquidate all the institutions in our industry tomorrow, you would probably have very little tangible net worth left and we've made that point over time. This points to the need for the kind of reform that we're talking about here in this series of hearings.

NEED A FAIR ALLOCATION OF COSTS TO S&L'S

But I, at the same time, have to emphasize that we have to give this industry a reason to believe that we can be fairer in the way we allocate the cost of risk so that they in turn can help you in the Congress and us because they will see light at the end of the tunnel, and find a way then to recapitalize the fund. And I know that we can do that with them if they believe that there is a long-term way out of this problem and we need the kind of incentive that this problem provides to push all of us to find those kinds of solutions and to seek the discipline necessary.

We have tried very hard, as you know, over this last year to try to bring greater discipline to the industry in some of the regulatory approaches that we have taken. I don't think we have finished, but there comes a point where regulatory action reaches a certain point and then we need the help of the Congress and the recognition of Congress.

In my own mind, given that we're talking about $785 million in deposits out in our institutions, many of them insured, I believe deeply that at least the implicit full faith and credit of the United States, which I believe the Congress would provide and perhaps I'm being presumptuous, stands behind those insured accounts in any event. I certainly hope so.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman.

Chairman Gray, do you feel that many of the problems you're facing now is because States have elongated the powers that Congress gave them?

Mr. GRAY. I'm sorry.

Senator HECHT. Have the States given the savings and loans more power than the Garn-St Germain Act?

STATES EXCEEDED POWER GIVEN IN GARN-ST GERMAIN ACT

Mr. GRAY. Well, I have to tell you, in all honesty, that the kinds of asset quality problems that we have seen, some of which have led to insolvency, some of which have led to failure and receiverships, have occurred in great part across the Sun Belt where real estate speculation has been the highest and where real estate direct investments have been the greatest. This has been the case because those States, such as my own State of California, have provided almost infinite authority to make direct investments at almost every level by their State legislative initiatives and I've been warning about this, as you know, for a long time. I have faced a resolution signed by 230 Members of the House of Representatives asking us to delay our direct investment regulation to try to

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deal with this problem, this very problem, and in the face of that, we have pursued the only regulatory means we have to deal with those kinds of problems.

Yes, I would agree that the magnitude of risk which the fund has been subjected to by virtue of these kinds of authorities has contributed to some of our problems, very definitely. That's why I tried to say in my opening statement, Senator, that I think that Congress hit just the right mix, new asset authorities combined with conventional authorities, in the Garn-St Germain Act. The Garn-St Germain Act provided for federally chartered thrifts a 3-percent asset basket in which direct investments could be made. California, in contrast, provided its institutions the ability to place 100 percent of their assets into service corporations and thereby make direct investments in virtually any kind of enterprise that the imagination allows.

Now there is a tremendous contrast between those kinds of operating authorities. And you know because you've been reading the papers that over the last several months we have taken into receivership and created new mutual institutions out of some very large California thrifts. And I have said before, that occurred because of fast growth and liabilities on the asset side and through the use of brokered funds to grow very fast. Much of that money went very quickly into these kinds of investments which frankly were not underwritten as well as they should have been. They tended to be characterized by very risky kinds of approaches to investing and lending and we are paying the price for that kind of thing now. We are paying the price.

Senator HECHT. Well, let's continue on now. If this is the case and as you allude to and state very specifically it is the case, what if Congress would just say, if you want FSLIC insurance, you adhere to our guidelines and the States have no authority? Wouldn't that solve the problems?

Mr. GRAY. I think there's a better way to deal with that because I support the dual State-Federal thrift system. That's why we are proposing this risk premium approach where an institution would have to pay a premium commensurate with the risk of loss to engage in these kinds of activities which involve, in large part, direct equity investments.

Now I must in all honesty tell you that there's been a problem in this regard. Some of those thrifts have been able to camouflage what were really direct equity investments as acquisition, development and construction loans, for example. The Board has taken action. We have finalized a regulation that deals with that now.

But, no, I would not suggest here that the Congress preempt State law totally and say the Congress from now on will make all the decisions about what operating authorities thrifts can engage in. No, I wouldn't say that. I say, give us a way to deal with the risk of loss to the fund. That's the best way to do it and I think it's the appropriate way and a far better way than the Congress trying to sit here and second-guess State legislatures. The Congress does, I think, have the responsibility to help us underwrite the risk of loss to the fund because there's only one fund that does that for most thrifts in our system.

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Senator HECHT. But if there is a default, it's the American taxpayer ultimately and the FSLIC that makes up the loss. It's not the individual States.

Mr. GRAY. You're right.

Senator HECHT. Now you just mentioned in your remarks moments ago Congress authorized 3 percent and the States gave 100 percent. How could you possibly come up with a risk insurance premium on that?

Mr. GRAY. We have checked. We have consulted rather extensively with one of the major international insurance consulting brokerage firms. We have gone through our whole approach with them and they believe it's possible. Now there may be some activities that carry such a high risk with respect to potential loss to the FSLIC that the pricing of that risk would make it virtually impossible for an institution to engage in those kinds of activities; but that's all right, as long as we know it, because it is the taxpayer, as you suggest, ultimately who is at risk, the Federal taxpayer ultimately is at risk. The States that do allow these operating authorities for their State-chartered thrifts never have to pay a penny for loss. They don't contribute in any way to my knowledge to the Federal credit that is provided from the Federal Home Loan Banks to these institutions. They don't guarantee any deposits. They did in Ohio and Maryland in a manner of speaking. That didn't work out very well. So ultimately, the responsibility for this FSLIC fund and for the Federal Deposit Insurance System ought to rest with Congress and we are the surrogates of the Congress in trying to deal as effectively as we can with the risks to the FSLIC, given the authorities that we have.

Senator HECHT. Do you think if Congress would set down these guidelines that if the States wanted to broaden these powers have them set up a separate insurance fund?

Mr. GRAY. Oh, I have said—and I will go back to last year—I said I really don't care what State-chartered thrifts do, if the States themselves establish a means by which they can underwrite the risk of loss themselves. But I saw no State breaking down the doors to do that. I haven't seen any of that along the way. I don't think that's in the cards at all. So it all comes down to us. It comes down to the Congress to decide how the Federal Government deals with this deposit insurance problem.

PROPOSED MERGER OF THE TWO FUNDS

Senator HECHT. One last question. It's a very simple question that's been bandied around the last few days. How do you feel about the merger of the FSLIC and the FDIC?

Mr. GRAY. Well, I will say again that that does not really solve anything. It doesn't solve anything. It doesn't address the insolvency of one thrift institution in this country. I suppose you could argue that there would be additional reserves available to do payouts on losses, yes, but what we really need here is deposit insurance reform where we will provide the kind of incentive for the thrift industry itself—and us working with them—to confront their own problems and to work them out. That's the way to do it, not

just to run away from the problem and say we're going to merge the funds. What does that do? Nothing.

Senator HECHT. Well, there are two types of institutions I feel, the savings and loan and the bank, and officers and examiners of the savings and loan are taught one way and officers and examiners of a bank are taught another way. Would that work out in any which way?

Mr. GRAY. Well, I'm glad you brought up examiners. May I just try to address it in my own way, Senator?

One of the things that I have been deeply concerned about, and I've been saying this for a long time, and I've been trying to make the case to budget officials and the Congress and at OMB that we need more examiners. Examination and supervision is the front line of defense for this insurance fund. Yet we have been limited to 750 examiners to examine an industry that is now has $1 trillion in assets. We are so far behind the other banking agencies in this regard that frankly it's embarrassing, and we at the Bank Board actually took these matters into our own hands last year when we sought through the law books provisions of law which would enable us to begin the process of transferring these examiners out to the Federal Home Loan Banks under delegated authority. We found that authority under the Garn-St Germain Act and the Federal Home Loan Bank Act, and on July 7 we made that historic transfer where we moved to the Federal Home Loan Banks examiners formerly in civil service status. We paid them entry salaries of $14,000 or $15,000, and an average salary of $23,000 or $25,000, in that area—now that they are in the Federal Home Loan Bank System, we don't have any salary constraints. We don't have any of those budget constraints. We can hire as many examiners as we need. We can pay examiners what it takes to make it worth training them and keeping them. We couldn't do that before.

I may not have been responsive to the intent of your question, but I have seized the opportunity to point out the progress that we have made in that regard, but I would say also that we have a continuing problem at the Bank Board. We have 114 people at the FSLIC, 114. FDIC has 5,000. We have 25 people in our liquidation division handling in excess of $2 billion in assets to dispose of. The FDIC has over 2,200. And we cannot get relief on that. That's why we are seeking the flexibility from Congress to be able to hire enough people at the FSLIC, the kind of people that have the sophistication in financial matters to be able to deal with these problems. We need relief on that. We need relief, very frankly, across the Bank Board itself, the entire staff, because I feel and I have experienced this particularly over the last year that frankly my hands are tied and we are hamstrung in our ability to have the amount of resources and the quality of resources that we need to do the job.

Senator HECHT. Thank you. My time has expired.

The CHAIRMAN. Senator Cranston.

Senator CRANSTON. I welcome my fellow Californian to this hearing.

Mr. GRAY. Thank you, Senator.

Senator CRANSTON. Historically, the business of thrifts has been the placing of mortgages, as you well know, on real estate. Why

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would there be any feeling that thrifts don't seem to be able to make the same quality judgments they should make in regard to what they're going to back and what they're not going to back and the viability of a real estate transaction when they are going to directly invest themselves in real estate or in something else?

Mr. GRAY. Well, I think we have to look at this in a historical context. The industry came out of the 1981-82 period in a very weakened condition and as these new authorities—such as our State, California—were provided for State-chartered institutions, these institutions actually felt encouraged to go out and use them. And, remember, they were in a relatively weakened or very weakened condition and this served as an incentive to gamble—what do I have to lose; I need that one-time upfront fee, and I can go to the money brokers and I can get all the money I want, like that. I can get on the telephone and there will be a wire transfer to me immediately.

MAGNITUDE OF BROKERED FUNDS

Now I warned about this last year over and over again, that all this was happening and we only found out about the magnitude of the acquisition of funds from deposit brokers after the fact. Institutions then used these funds to grow fast, some of them to grow out of their problems, which is not a very good strategy frankly. They would take the funds and invest them all too quickly without proper underwriting to get the upfront fee, to gamble, and if it all worked out, great. Unfortunately, in too many cases, it didn't work out. It just didn't work out and we are paying the price for that right now.

Senator CRANSTON. Isn't the root of the problem where problems do exist, and they do, basically fraud or conflict of interest accompanied by poor underwriting? Isn't there some other way to get at those major problems other than restricting direct investments for every thrift institution?

Mr. GRAY. Well, examination and supervision, particularly examination, is an after-the-fact matter. We don't manage these institutions. We don't do the loan underwriting for them. We don't do the underwriting for investments. We can't do that.

Yes, there have been instances and there will continue to be instances of fraud, false reporting, and so forth. And when we learn of those, we try to deal with them in the ways that are available to us through enforcement authorities, and other means. But the magnitude of the problem is so great, it's not just limited to California, it goes through a lot of other States, and since we don't have the means by which we can price the risk of loss for these activities which they are engaged in, the only thing we could do, Senator, was to use our regulatory authority to try to deal with this and underwrite it in a regulatory fashion. And we devised as best we could a scheme by which there would be a review threshold by us as supervisors of these institutions. We established that threshold at 10 percent, which is much higher than that provided for any federally chartered institution. And we said at that time, if you're involved in these direct investments, we want you to come

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in and we want to review it to see whether you should go above that threshold.

We thought that was prudent as an underwriting mechanism for the FSLIC itself and I am still convinced that that was absolutely the right thing to do. In fact, we might well have gone further.

But it has been very difficult with the resources that we have had, which have been in very short supply, as I have suggested, to even keep up with some of these problems. It's a miracle to me that we have been able to do as well as we have under those circumstances.

And using all the authorities that we have had, the resources of supervision, we have tried to keep on top of these problems, but they have occurred very, very quickly and it's just impossible to track all that money coming in from the broker and going out very fast, it's all done—it's all done. The investment has been made. The loan has been made before we find out about it. That's the problem.

Senator CRANSTON. On the matter of risk-based insurance there's been a lot of talk about that in the thrift industry. Have you found, or do you believe there would be any chance of finding a private insurance company that could or would consider taking up this responsibility?

Mr. GRAY. I think the magnitude of the challenge that we face is simply too great for the resources of any single insurance company and if I were an insurance company or represented a group of insurance companies, I would want to make very sure that we had a means, perhaps along the lines of the scheme that we've proposed, to underwrite that risk because no insurance company can long survive if they can't underwrite the risk of loss. And it has been suggested, for example, that if the private insurance industry substitutes itself for the FSLIC, things would change very substantially in terms of how thrifts operate and what they would pay for that kind of insurance.

Senator CRANSTON. In a recent public statement, Mr. Hovde said that the thrift industry, because of the falling interest rates, would show a profit of somewhere between $4 to $7 billion this year and he said that 90 percent of all thrifts would be in the black compared to 72 percent last year, 61 percent in 1983 and only 22 percent in 1982.

PARADOX IN THE S&L INDUSTRY

Yet failures are occurring meanwhile at a greater rate than last year. How do you explain that paradox?

Mr. GRAY. Well, I agree with Mr. Hovde and I think that many analysts who have looked at the industry would agree that the industry this year has a great opportunity for profitability that could rival anything that the industry enjoyed in the last decade in the halcyon days of the mid to late 1970's.

I would agree that it's possible that the industry could earn $4 to $7 billion or more, depending on where interest rate levels are.

Senator CRANSTON. How do you explain that so many are going broke meanwhile?

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Mr. GRAY. Well, you have a dichotomy in the industry then. You have a number of institutions that are in trouble and on their way to insolvency or there. Interest rates for them are not going to do the trick. They are not going to turn around even if you halve the interest rate level right now. And these problems result from the residual effects of the period in which the industry was weakened. They result from highly speculative ventures which have gone sour. It is very difficult to resuscitate institutions like that.

So on the one hand, we have most of the industry that certainly could have a very profitable year and it perhaps could be 90 percent. I would hope so. On the other hand, we have institutions in a certain category, if you will, that have been moving inexorably in that downward direction and there is simply very little, if anything, that can be done. That's why we need acquirers to help us deal with this problem and we need time to work it out to give the industry reason to have confidence that we can have an insurance plan that really is fair to all the participants in the plan.

Senator CRANSTON. Mr. Chairman, I have some further questions but I will submit them for the record. Thank you.

[See p. 576.]

The CHAIRMAN. Senator Dodd.

Senator DODD. Thank you, Mr. Chairman.

Let me if I can briefly here pick up on a couple of the questions that were raised by Senator Proxmire. I understand he asked you about additional disclosure on the part of thrifts and that you were not terribly concerned about that, although you wouldn't want to rate lending institutions based on disclosure, and that you also were not concerned that further disclosure would raise the possibility of some runs.

DISCLOSURE OF ADDITIONAL INFORMATION

What additional information would you like to see thrifts have to disclose that they are not presently disclosing?

Mr. GRAY. Well, they obviously are supposed to report all——

Senator DODD. I'm not talking about what they're supposed to do now. What additional information would you like?

Mr. GRAY. Well, in all honesty, we have reviewed this and I think that under the present circumstances we have just about the right disclosure. Of course, publicly held institutions have to disclose under the law. For mutual institutions—which are not held by stockholders but rather their owners are the depositors in the institution—their accounts are insured by the FSLIC and the disclosure with respect to mutual institutions or privately held institutions that are not publicly traded where the investor would certainly know the condition of the institution, I think that there's a proper mix of disclosure that takes into account letting investors know what the situation is but at the same time not prompting a lack of confidence in other institutions which would work against what we're trying to do. We're trying to maintain confidence in our financial institutions.

Senator DODD. They're not publicly traded, but nonetheless they are required to meet certain Federal regulations.

Mr. GRAY. That's true.

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Senator DODD. In that regard, I presume you're not suggesting that there not be additional or improved disclosure techniques so that we—those of us both from your standpoint and ours—are familiar with what is going on. Obviously, a problem in those, while they are not publicly traded, can create the kind of situation which can spread like a brush fire very quickly.

Mr. GRAY. That's true, and we try very hard every day to try to keep that from happening because that would be totally counterproductive for you in the Congress and for us.

But on review of our disclosure procedures, I am persuaded that right now, while we may be able to do some refinements, that we have just about the right mix necessary under these circumstances. If things were different, if we didn't have nearly as many problem cases, it might be another matter, but we're dealing with the situation as it exists today.

Senator DODD. Again, picking up on what Senator Proxmire was driving at—and I missed some of it so I'm picking it up secondhand, so, Bill, if I misstate what you were driving at, jump in here—but just dealing with the question of capital requirements, regulations require 6 percent. Now there's probably nobody in this room who believes for a second that that's the case in every institution. We're talking about from the regulatory standpoint they are reaching the 6 percent, but with goodwill and a lot of other things.

Mr. GRAY. Actually, it's 3 percent in the thrift industry.

Senator DODD. Excuse me, 3 instead of 6 percent. There is what I call a regulatory standard has been met. There are things that fall under the category of reaching the capital asset requirement, a lot of blue smoke and mirrors, and I suspect not many people in this room would disagree with that. So while you're getting a regulatory figure, the actual figure is somewhat less than that.

I guess I should have prefaced all of my questions to you by saying that underlying all of this is the question of confidence, which is really what we're talking about.

Mr. GRAY. Sure.

Senator DODD. And that we get the kinds of reports and so forth that come out that raise questions in our minds about confidence and aren't we really deluding ourselves if we're pretending that in fact these problems don't exist when in fact they do, and we end up with situations that emerge which erode even further the confidence, and you get this snowball effect.

Wouldn't we be wiser to be more candid and forthright as to what the problems are now and talk about long-term solutions such as you have, risk-related premiums and so forth, and start making some tougher decisions for the short term to deal with the problems, rather than pretending they don't exist?

CAPITAL ADEQUACY GOES BACK TO THE SEVENTIES

Mr. GRAY. Well, we certainly do not pretend that they don't exist. I want to assure you of that. Anyone who has talked with me privately—and I haven't had the opportunity to talk to you privately—anyone who has talked to me knows that very well. But again, there is a capital adequacy problem and there has been for some time in this industry. It goes back to the 1970's. This is not

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anything new. Because of the difficulties in 1981 and 1982 which the industry encountered, there was almost no choice. At that time we were losing 750 institutions. My predecessor, Chairman Pratt, who you will talk to later, was at that time faced with precisely that problem, and he did what he had to do. And historically the capital standards included calculation techniques such as a 5-year averaging arrangement and what we call 20-year phase-in which had very distortive effects which enabled institutions to leverage very heavily for funds in the market. It worked out that in too many cases it was high levels of brokered funds.

So the capital continued to decline. Now we could tomorrow by fiat say that the new capital standard for this industry would be 4 percent. I don't think that would produce 1 penny of additional capital for the industry. It would place more institutions in the supervisory category, no question about that. So just declaring a higher net worth standard doesn't do the trick.

Senator DODD. I'm not advocating that.

Mr. GRAY. Right. But this is why we adopted the new net worth regulation, which phases out the distortive effects of the previous net worth scheme over a period of time, and which requires institutions that are growing to earn their growth. I think this has been the most salutary thing that we could do. We had growth last year, for example, of 20 percent in the industry as a whole in assets. That was compared to growth in the commercial banking sector of between 6 and 7 percent. And we had many institutions that were growing far faster than that. I mean, some in the range of 200 or 300 percent. I believe there was one institution that was growing at a rate upwards of 1,000 percent a year.

What have been the effects of our regulatory action? Well, the first quarter of this year, the growth of this industry was not 20 percent on an annualized basis, but slightly less than 5 percent, which gets us back into the same area of growth of the commercial banks. So our concept under the circumstances has been to require the discipline whereby an institution would have to earn its growth in the future. That's what's happening now and it's had very good effects and I think that it also is having another effect. That is, the cost of money for many institutions is coming down simply because they are not out gathering funds in this frenzy which was occurring last year. And every basis point that you pay for funds higher than you would like or ought to pay is money that you save for the net worth of the institution and, that is to say for the capital of the institution.

So it's also beginning to have that effect. There is real evidence of that.

Senator DODD. Let me ask you this as well. You've been pretty candid here this morning and again talking about the 10 percent of institutions that have no net worth and of the exposure of potentially $15 billion. The chairman's point that this doesn't all happen at once, but I think Senator Proxmire's point is an excellent one. There is at least a potential crisis out there. That's no reason for everyone to run for the hills. And you've been honest enough to say it's a real problem, sitting right here in front of us.

And yet you have also expressed, as I understand it—you correct me if my information is not right—that the recommendation that

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the FDIC and the FSLIC be joined—obviously there would be those who would be concerned about this in the commercial banking side, but there is at least one short-term possibility of helping to alleviate the potential problem we have by combining those two.

Do you object to that proposition? Is my information correct? And if so, why, in light of your candor this morning about the problem?

MERGER WOULD NOT SOLVE ANY PROBLEMS

Mr. GRAY. Well, I certainly do object to that because it would not solve any problem in our industry. That's what we ought to be trying to get at—the problems in the industry—we need to address them and to make sure that we use this as an incentive for reform. It is very important that we not run away from the problem based on assumptions or projections that liquidations would amount to whatever level. What we need to recognize is that these things don't happen overnight. Any company, any thrift, any bank, has cash flow problems. That's what we have I think. I'm not trying to oversimplify this. It is a cash flow problem and I think that we can deal with it if we send the right signal to the industry that we are going to deal with it. I think the industry under those circumstances would have a reason to have an incentive to face up to the need for recapitalization of this insurance fund. And perhaps I'm optimistic on this, but I think they would be far more willing to come up with measures to accomplish that.

Senator DODD. Thank you for your response to that. My time has expired. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

Chairman Gray, I understand from Governor Hughes that you and your staff have been working very closely with the Governor and the State personnel on the Maryland savings and loan situation. How do you see that situation progressing?

Mr. GRAY. Well, as you say, we have been working with State officials very closely. We had a meeting last night, as a matter of fact, to discuss some of the problems and some of the possible solutions in certain cases where through expediting the process, as they certainly agree we have been doing, we can help them with their problem without in any way compromising the standards for admission to the FSLIC.

I can only tell you that I think great progress is being made. Governor Hughes indicated that to me, and I think there's a general feeling that we are definitely on the right track and we're trying to help support the initiatives that they are taking which address their multitude of problems.

Senator SARBANES. Well, I want to encourage you to continue to be responsive in dealing with the State in addressing the situation. I know the State has committed itself in perhaps an unprecedented way, to addressing this issue, and I am hopeful that through your joint cooperative efforts we will be able to work it out. There are some indications that that prospect is in the offing—I simply want to encourage you to continue.

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INDUSTRY COOPERATION

Let me turn to a broader question. Is the industry joining in any meaningful way in the effort to address the question of asset quality, and the operating problems which you have identified as existing in the industry?

Mr. GRAY. Is the industry moving?

Senator SARBANES. The industry itself?

Mr. GRAY. Well, we have a very diverse industry and I would say that there is a large segment of the industry that has certainly recognized the magnitude of the challenge we face. There are some institutions that have been, in my view, rather reluctant to face up to these things.

It's hard to characterize this industry in a particular way. I think, in all honesty, it has taken a long time for the industry to recognize that even though we're operating in a deregulated environment, these institutions are also operating with a Federal safety net to protect depositors. And while I think facing up to these problems has been a little too long in coming, we have made great progress in that regard—great progress.

Senator SARBANES. The reason I ask this question is, of course, that in your testimony you make the point that certain regulatory actions taken by the Board were very strongly opposed by elements in the industry.

Mr. GRAY. That's true.

Senator SARBANES. Which raises the question, first, do they disagree that the problem exists, or, second, do they concede that the problem exists but assert that there's some other way to address it? And, if the latter, what are the merits of that assertion?

If the problem is as serious as it's being laid out to be—and I tend to think it is—I'm concerned that the industry is not coming to grips with it. After all, if it's not adequately addressed—and the Board I think has been trying to take preemptive protective action—if it's not adequately addressed, the whole industry is going to be in a very, very difficult situation.

Mr. GRAY. Well, I think that many institutions have come to a strong recognition of the problem. I think there are some out there—and I have to identify them as the go-go folks and the high-risk players, the high flyers—that probably are not going to come around to recognize these problems and, unfortunately, we have too many of them. But as I tried to say before, one of the problems, particularly for those institutions that have the highest levels of net worth and therefore contribute greatly and would be called upon to contribute greatly to the fund in order for it to meet its obligations, is that these institutions feel that there is an unfair allocation of the cost of risk to them and they have not known how to get at this problem. These are, I would say, among the most responsible members of this industry.

It's been very frustrating to them and, again, if we can provide a means by which they can see some light at the end of the tunnel, and see that there will be reform which will far more fairly allocate the cost of risk, then I think they will have the incentive and will be far more willing to deal with the capitalization needs of the fund.

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So it's that frustration that exacerbates this mix of attitude in the industry and the frustration involved.

Senator SARBANES. Do you think the public, in making a judgment about safety and soundness, is going to differentiate amongst institutions on the basis of the risks they're taking and the premiums they're paying? Won't the public tend to see them all in one category and treat them that way?

Mr. GRAY. Well, I think it would under certain risk premium schemes, yes; but I think in this particular case that would not be the case because an institution would, first of all, before it could even become involved in an activity, have to be able to make the premium payments to do so. And if it couldn't make the premium payments to do so and saw the premium payments because of risk of loss being too high, it would no doubt opt not to go into those kinds of more risky activities.

By the way, as I said before, for those institutions with higher and higher net worth, the supplementary premium that they would pay, to the extent that they were involved in these activities, would be less and less.

Senator SARBANES. But how are the conservative institutions going to make clear to the public that they are following very safe and sound S&L practices, as opposed to the more aggressive go-go people who are taking much higher risks? How is the public going to know that this is one kind of institution and that's another kind of institution and that you take quite a different risk depending on where you're going to place your money? If that distinction isn't made, isn't there going to be a tremendous pressure for institutions to keep going further and further out to present a more aggressive posture to the public, and the public is not going to be able to make a distinction as to risk?

Mr. GRAY. Well, again, they would have to pay the supplementary premiums which would be priced for the risk of loss and institutions would take that, I think, strongly into account before they chose to engage in those kinds of activities.

Senator SARBANES. Well, except that when the interest rates went up—and this is not totally analogous—what we found here in examining lending practices is that the highly speculative ventures still went ahead because the prospect of return was so great that it would cover the higher cost, whereas it was the more traditional solid practices which brought just a reasonable return that were being squeezed out because of the costs associated with it were too high.

Mr. GRAY. That's absolutely right. And I think that makes the argument for the risk premium we're suggesting. They have been able to undertake these speculative gambles on what is essentially a group insurance plan. The speculators pay exactly the same proportional premiums as the conservative, well-run institution. So there is a perverse incentive there.

Senator SARBANES. I understand that. All I'm suggesting is that if you allow them to pursue the other, there's still going to be a pressure to do it since the return they anticipate would more than offset the extra premium cost. So, you're still going to be pushing the industry in that direction.

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RULES CHANGE AT 3 PERCENT

Mr. GRAY. The way I would answer that is that when an institution reaches the point of 3 percent or less net worth, it becomes in effect a supervisory case, and when it becomes a supervisory case, all the rules change—or certainly all the rules can change and should change. And at that point in time, the regulator has the ability to bring about supervisory agreements, or when circumstances are appropriate to issue cease and desist orders; and cease and desist orders can change management, limit the kinds of activities conducted, and can carefully control through oversight the kinds of strategies that these institutions follow. So the rules change when you get below 3 percent.

Senator SARBANES. I guess my time is up. I would just close with this observation. It seems to me that we still have to maintain the regulatory aspect of the responsibilities and my concern is heightened by the fact that when the Board took important regulatory actions it received such a tremendous negative response from significant elements in the industry, even though everyone——

Mr. GRAY. That's true.

Senator SARBANES. Everyone was saying we're facing an increasingly serious situation.

Mr. GRAY. Well, you know, the squeakiest wheels get the attention and the squeakiest wheels went to those 230 Members of the House, most of whom I believe didn't even know what they were signing. They signed a resolution asking us to delay the effective date of our regulation, and in our minds that wasn't really asking for delay, it was asking for that to go away. And there are very powerful institutions in this industry, powerful enough for whatever reasons to bring about that kind of action, and that kind of action even on the part of Members of the House, and that was of great concern to me. But I think I know enough about the political process to recognize that probably most of those Congressmen didn't know what they were signing.

So we did not yield on that. We went ahead, and I'm happy that we went ahead because we were right. And I have to say here, as a personal note, that from the fall of 1983 I have been warning about these same problems time and again. If you read my speeches and congressional testimony, they are replete with warnings over and over again that the risk that the FSLIC was expected to bear—without the ability to underwrite it except by regulatory fiat—was mounting geometrically as a result of rapid growth, and excessive use of brokered funds instantaneously accessed.

I have to say I did not succeed in effectively communicating that message because for too long a period of time there was a kind of ho-hum attitude in this industry. That's changed. I think we have made great progress in that regard, but there are still some in the industry who find some of the things we've done to be very distasteful, and in fact some of them suggest that they are very hurtful to the industry's prospects for profits, and so on. And I suppose we're always going to have that element of the industry, with any industry, to deal with.

Senator SARBANES. My time is up. Thank you very much.

The CHAIRMAN. Senator D'Amato.

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Senator D'AMATO. Thank you very much, Mr. Chairman. I would like to submit a statement for the record as if read in its entirety.

The CHAIRMAN. Without objection, so ordered.

STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Good morning, Mr. Chairman. Today this committee will continue its examination of the Federal Deposit Insurance System in this Nation. Before we begin, however, I would like to welcome our distinguished panel of witnesses. I appreciate their taking time from their busy schedules to testify today.

Over the past year, the Federal Deposit Insurance System has become the center of concern for several reasons. Many banks have been involved in overseas loans which have not panned out. The question of whether these nations will ever repay these debts remains unanswered. The instability of these loans increases the instability of our whole banking system. Default by one of these nations could have a drastic effect on the entire financial services industry.

Along with the instability created by these foreign loans, there is the increased frequency of bank failure in this Nation. The reasons a bank fails or why it reaches a point of insolvency must be answered.

These problems raise serious questions about the adequacy of the Federal agencies examination process, enforcement actions, disclosure requirements, and methods of assessing deposit-insurance premiums, and whether the insurance funds are large enough to adequately protect the industry.

Questions must be answered. The time for action is now. The public is quickly losing confidence in the deposit insurance system's capability to maintain an equitable and safe financial system. Their confidence must be restored.

Thank you, Mr. Chairman.

Senator D'AMATO. It's good to see Chairman Gray here.

Mr. GRAY. It's good to see you.

Senator D'AMATO. I'm interested in the idea that we would have FDIC insurance and premiums paid with a differential based upon certain criteria.

As I heard some of your testimony, Mr. Chairman, it seemed to indicate that riskier activity would be the basis by which the premiums would be assessed, or one of the bases.

Mr. GRAY. That's the way insurance companies do it.

Senator D'AMATO. What would you classify as riskier activity? For example, if you might spell out, how would the system work? What activity would you say there should be a higher premium charged for?

Mr. GRAY. Well, we have taken the position that the Congress in 1982 in the Garn-St Germain Act established what it felt was suitable for Federal deposit insurance supported by this group insurance fund that we have in the industry. What I am saying is that those activities which go beyond the confines of the Garn-St Germain Act, particularly in the direct investment area but any activity that goes beyond what the Congress has found suitable for Federal deposit insurance——

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Senator D'AMATO. How about brokered deposits, would you charge a higher premium? Are they riskier?

Mr. GRAY. Well, no, I don't think we're talking about subjecting the brokered deposits to a risk premium.

Senator D'AMATO. What about bonds? Riskier?

Mr. GRAY. What kind of bonds?

Senator D'AMATO. Well, some people call them high yield.

Mr. GRAY. You're talking about——

Senator D'AMATO. Some people call them junk. It all depends on what your perspective is. What about Ginnie Maes?

Mr. GRAY. Well, let me put it this way.

Senator D'AMATO. Let me tell you something. When we get into this business of trying to say that you're going to assess the premiums—and we're talking about FDIC—I'm going to be very easy on you.

Mr. GRAY. You're not talking about the FSLIC?

Senator D'AMATO. We're talking about the FSLIC. We're talking about insurance and the basis for establishing the premiums and if we're going to talk about riskier activities I'm going to suggest to you that that is absolutely the inappropriate way to approach it. I mean, we can say brokered deposits—bad, oh, very risky; bonds—bad, very risky; Ginnie Maes—oh, good. What about Treasuries? Oh, good. But more banks are in trouble today as the result of, I dare say, imprudent investments in taking that little premium on Ginnie Mae's than they are on junk bonds. You'd better look at the management. It's the management criteria. It's the capital base.

LOOK AT PERFORMANCE

So I get a little bit tired of hearing this business of you're going to have premiums and witness and witness based upon risk. You've got to look at performance. Those people—and there have been more people who have lost money in shopping centers when they don't know what they're doing and bad loans in energy and other areas. So what I'm going to suggest to you is you'd better look at the performance, you'd better look at the capital structure, and if we think we can come up and design some program that says junk bonds, we'd better have a higher premium. After all, they're junk. They're not rated. Brokered deposits—higher premium. But Ginnie Mae's, after all, we'll lower that rate. I think we're going to run into some big trouble.

Now if I have misinterpreted your intention I am sorry, but I thought I had to pose this question.

Mr. GRAY. Well, I won't suggest that you have misinterpreted it, but let me tell you what our version is.

First of all, we would take into account net worth. We would take into account the net worth of the institution in determining the supplementary premiums.

Senator D'AMATO. If that was 6 percent, what would you say then? Would you give it the best rating?

Mr. GRAY. Well, the higher the net worth—and there are certainly institutions that have net worth higher than 6 percent—the higher the net worth, the lower the supplementary premium.

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Senator D'AMATO. Would it pay any supplementary premium, for example, if it had all of its investments in an area that you considered to be high risk but yet its performance has been outstanding? What would you say then?

Mr. GRAY. Well, let me answer it this way. You know I'm from California. I'm from the agricultural area of California and I know that there are crop dusters out every day doing their job, spraying the fields, and crop duster pilots, whatever their track record, every so often you read that one hits a power line. However good a crop duster pilot he is, that is a riskier kind of activity.

I suggest to you that if he went for a life insurance policy he would have to pay a higher premium for that. That's a risky activity that he engages in.

Senator D'AMATO. Are we saying that you are going to be able to make distinctions between investing in Ginnie Mae's at a time when the market rate is moving up as opposed to something that you might consider to be—someone establishes is more riskier—a shopping center? Which one is more risky?

Mr. GRAY. Well, we have not professed at the Bank Board to have that expertise, but we know that the insurance sector in this country does have that expertise.

Senator D'AMATO. In this area?

Mr. GRAY. Well, they have to rate all kinds of risks for all kinds of companies all the time. Otherwise, if they don't do that, if they don't price that risk, they won't be in business very long. They've got to underwrite the risk.

Senator D'AMATO. Let me just suggest to you that when we come before the Congress and when the Congress considers what the premiums should or should not be in these areas and if they're going to attempt to rate what the premiums will be in terms of the loan portfolios that are out and not based upon what the performance is, not based upon what their capitalization is, but in terms of that area of activity, it runs a very great risk of indeed imperiling a system that's worked pretty efficiently I think.

Mr. GRAY. Well, we've talked about some of the problems of the system today and there may be some issues raised as to how effectively it has worked.

Senator D'AMATO. Well, that's the regulators who have really done—and I'm not talking about yourself, but I'm talking about the bad loans that were made—that has been building up over years because of under political considerations there were no risk factors involved there. We should have gone in and said, you can't make this loan, we're not going to insure it.

Mr. GRAY. But Congress didn't do that.

Senator D'AMATO. That's right. But that's not because of the failure or any risk system that would have done any better.

Mr. GRAY. But I have to ask, do you think it's fair for a conservatively well-run institution——

Senator D'AMATO. Wait a minute. What's this business about conservative institution? Take a conservative institution, again, is that an institution that buys all the Ginnie Mae's? Is that a conservative institution?

Mr. GRAY. Well, let me put it this way.

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Senator D'AMATO. Why don't we say well-run and drop the word conservative?

UNFAIRNESS OF PRESENT SYSTEM

Mr. GRAY. All right. Let's say well-run institution, the non-high flyer, if you will, the non-go-go type. OK? Would you buy that? Why should the well-run institution over here operating prudently and responsibly as a financial institution pay the same proportional premium as the high flyer, the go-go guy? Why?

Senator D'AMATO. Now what do we mean by high flyer? We might agree. You and I may very well agree if you would try to give us a more definite term about high flyer.

Mr. GRAY. Well, I'm talking about the problems that come from operating here on the flat rate deposit insurance system we have now.

Senator D'AMATO. Are we talking about—is Columbia Savings out in California, is that a high flyer?

Mr. GRAY. I'm not going to talk about any institution.

Senator D'AMATO. Well, I need an example.

Mr. GRAY. No, I'm not going to talk about any institution.

Senator D'AMATO. OK. Mr. Chairman, what I'm attempting to say to you is when you come in and tell me high flyer, are we saying that they're imprudent?

Mr. GRAY. Right.

Senator D'AMATO. Are we saying that the management—well, we agree then.

Mr. GRAY. Yes.

Senator D'AMATO. We look at the management. We see if it's a prudent management. We see what the investment return is. We see whether they're losing money or whether they're making money. We see what the capital structure is, don't we?

Mr. GRAY. Well, we've tried to take into account capital, the capital of the institution.

Senator D'AMATO. OK. I'm just suggesting to you that when we broad brush these terms we almost in certain vantages conservatively run, well-managed, you know—we're all for that and we all want them to have the lowest premiums available and try to tell me what that is.

Mr. GRAY. Well, what I'm trying to say is, of course, there ought to be better underwriting by more institutions in the industry. I think many institutions would agree with that. But what we're saying is that when any business applies for an insurance policy, the insurance company can only underwrite effectively if it asks questions and takes risk into account.

Senator D'AMATO. Junk bonds? Higher premiums?

Mr. GRAY. Well, higher premiums might be appropriate depending on the risk of loss to the FSLIC, and that would not be determined by us. It would be determined by people in the private sector insurance industry who do this every day for a living.

Senator D'AMATO. Now we've turned over that responsibility of setting risks to the insurance industry because they've done it every day for a living and, you know, I don't have to tell you to take a look at—I don't want to get my friends in the insurance in-

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dustry upset, but some of them have been in some substantial trouble that rival some of the bank failures we've had.

But, Mr. Chairman, my time has expired. I'm just suggesting that this is a lot more complex than coming forward and talking about conservatively, well-run, managed banks as opposed to some indistinguishable high flyer operation, and I'm just saying we use the word junk bonds, bad; Ginnie Mae's, good.

Mr. GRAY. I haven't even discussed that today.

Senator D'AMATO. I know, but, Mr. Chairman, this is the kind of thing that we have put before us on a regular basis. I'm suggesting there be a little more indepth review before call for a charge and a rush to come up with these variable rates, and I'd like to know on how we're going to come up with these rates. I look at performance. I look at the capital base. I look at the track record. Those are the kinds of things we generally factor in for establishing a rate base.

Mr. GRAY. I think all those things have to be taken into account. There's no question about that.

Senator D'AMATO. It's good to see you again.

The CHAIRMAN. Senator Riegle.

Senator SARBANES. Mr. Chairman, if Senator Riegle will yield for a second, some of us don't shy away from the use of the word conservative.

Senator D'AMATO. I think it can be used many times as an all-encompassing, wonderful good thing, and I like to wrap myself with that and I like that and I approve of it, but I don't want to see it used——

Senator SARBANES. By others?

Mr. GRAY. Perhaps I should have used the word "prudent" instead of "conservative."

Senator D'AMATO. Yes, I'd like to see that. Then we get to what's prudent and how do you gauge it.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you.

First of all, Chairman Gray, I want to say I appreciate how hard you work at your job. It's been a demanding job and I think you've been a very forceful advocate for the industry's needs and future as you see it and I appreciate that effort.

Now I want to follow along just a bit the discussion that you've just been in. That is, on page 6 of you testimony you recommend the supplementary risk premium for activity groupings which:

> Essentially fall outside the confines of what the Congress found to be suitable in the 1982 Garn-St Germain Act for Federal deposit insurance thrifts.

Without getting into institutions as such, I would be interested in a description of the activities or the practices that you're thinking of when you make that kind of reference in your statement.

Mr. GRAY. All right. As you will recall, Senator, in 1982, the Garn-St Germain Act provided some additional authorities for Federal thrifts to extend credit both for mortgages and for commercial lending, including commercial real estate lending, within certain asset baskets.

Congress also maintained the 3-percent asset basket for service corporation activity, which translated means the ability to make direct equity investments at 3 percent.

What has, of course, happened over time is that there has been this trend on the part of State legislatures to go somewhat beyond what the Congress found suitable for Federal thrifts. And in the case of California, as an example, the legislature there said that institutions could place 100 percent of their assets, all of the assets of the insured institution, in a service corporation; not 3 percent, but 100 percent. And as a result they could go out and make direct equity investments in real estate almost at will in any kind of endeavor or enterprise they wished, any kind.

TRIED TO GROW OUT OF THEIR PROBLEMS

The contrast to Federal S&L authority is striking, and there are a number other States which have taken a similar route, particularly in the Sun Belt. But the trend is certainly confined to any region. And so when this happened, there was a desire on the part of some State-chartered institutions to try to grow out of the interest rate problems that hit them in 1981 and 1982, even though the fundamental quality of the assets was good. Their assets were for the most part long-term fixed-rate mortgages. They just didn't happen to be yielding at the level of the cost of money and, as I pointed out, we lost roughly 750 institutions in that period. Most of these occurred through voluntary merger, but some of them were forced mergers with FSLIC assistance.

And so as we moved into this deregulated liability environment of 1983 and 1984, where institutions could pay as much as they wanted for funds, where there was an open marketplace—we had the money market deposit account and the liability environment now is virtually totally deregulated—institutions began to seek fast growth. Many grew excessively, and they accessed large amounts of money, and in all too many cases, they were quickly, invested these funds in all manner of activities without good underwriting. This was particularly the case for institutions which had more liberal State-authorized operating flexibility. Not all did that. I certainly don't want to leave that impression, but some did. Too many did.

Senator RIEGLE. Here's what I'm wondering. Would we be better off considering trying to in some fashion limit the authority to make wide-ranging commitments or is it better to let that just take place and in a sense set up a two-tier insurance system where you treat the one set of players who follow a certain strategy one way and one the other way?

Mr. GRAY. By the way, I think that's just about what we're suggesting. We have a group insurance plan. We're suggesting, in effect, a supplementary insurance plan for activities that go beyond what Congress has authorized for Federal savings and loans.

Senator RIEGLE. I guess I'm asking you a little different question then in terms of your own professional view of it. That is, are we really better off encouraging that kind of activity even if we have a higher risk premium that attaches to institutions who move that way, or should we be thinking about whether or not that's a direction we want to take. Perhaps we ought to try to take a new look

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at the range of activities or the percentage of activity that can go off into these riskier categories as you see them. I mean, maybe we're better off looking at both sides of that proposition before deciding necessarily that a risk insurance premium is the answer.

Mr. GRAY. Well, I suggested in my statement that there is merit certainly for the sliding net worth scale that some have talked about and I think in the last hearing you suggested that we take a look at that. We have continued to believe that certainly while that has merit—and I would rather see that than nothing, absolutely—one could disagree as to whether that's a better approach compared to this approach. I have an open mind on that.

But I know that we have to bring about some kind of reform, and we have to more fairly allocate the cost of risk.

Senator RIEGLE. My concern is that I don't want the unsound thrift hiding behind the sound thrift, and with the deregulated environment, one that's in difficulty being able to go out and bid up the price for money and appear on the surface to be sound and in fact not be sound—then this in a sense, creates a jeopardy for everybody else.

Could you provide a list for the record—I don't want to get into the institutions, but I would like to get some better sense of the practices that trouble you the most.

Mr. GRAY. Yes. I will say right at the outset in this hearing that the activity that troubles me the most is direct investment in real estate. That has caused the biggest losses for our fund.

Senator RIEGLE. And to what extent is this occurring? Can you size the problem for us?

Mr. GRAY. It's occurring in too many cases and we see it in our monthly review of all of our problem cases. We see this as being by far the biggest problem.

Senator RIEGLE. A growing problem?

Mr. GRAY. I think that with the adoption of our net worth regulation and our direct investment regulation that we have now gotten a handle on that problem. So I can't say that it is growing, but the residual effects of that kind of activity will be with us for some time in terms of our problem cases, troubled cases.

Thrift failures in 1984 due to asset quality problems represented 70 percent of total failures. Of the 14 assisted acquisitions or liquidations to date, in 1985, all were directly attributable to such problems. The cost of resolving these cases has proved costlier than those involving failure due to interest rate spread problems. In 1984, assistance for asset related failures amounted to 27 percent of total assets of failed thrifts compared to 3 percent for spread related failures. Unfortunately, a forecast of troubled institutions shows that the asset quality failure trend—and therefore the trend toward increased assistance—is continuing.

With expanded asset powers, the penchant of many thrifts toward rapid growth and direct investments has resulted in many unsound investments in speculative assets which have inevitably led to a greater potential for loss. Nowhere is this hazardous phenomenon more apparent than among State-chartered institutions. Broader State-charter authority in some States has enabled these institutions to undertake much greater risks through enhanced

product and service authorities which far exceed those allowed federally chartered thrifts.

For example, let's look at Texas and California. Texas has legislated powers to State-chartered thrifts that include powers to make land development loans; powers to invest in corporate bonds and securities; broad service corporation investment authority; and broad powers to acquire, subdivide and develop real property for residential and other purposes.

California has completely deregulated the asset powers of State-chartered thrifts. By statute, up to 100 percent of a California institution's assets may be invested in real estate or in a service corporation. Such leeway has led to investments in windmill farms, corporate equity securities, junk bonds, and large scale real estate development projects.

An analysis of State-chartered institutions in Texas, which are current FSLIC cases or which are projected as FSLIC assistance cases requiring assistance within 12 months reveals that 71 percent of these cases can be directly associated with the abuse and misuse of the direct investment authority. At this time it is estimated that the cost to FSLIC to resolve these cases will approximate $750 million.

The most common abuse committed by these institutions has been the investment of a substantial portion of their resources in the organization of, or participation in, loans, for the acquisition and development of real estate, including the construction of improvements thereon. In most cases, the loans were based on appraisals predicated on land-flips. Generally the loans or investments portrayed one or more of the following high-risk characteristics:

The lender assumed virtually all of the risk by providing all, or substantially all, of the funds while the borrower, although legally holding title, had little or no equity in the property.

The transaction was structured to maximize front-end profit recognition through the charging of commitment and/or other loan fees which were actually funded by the lender.

Accrued interest was funded by the lender and was recognized as income throughout the term of the project.

Either no arrangements for permanent take-out financing were made or the lender verbally agreed to convert the loan into some type of permanent financing upon completion of construction.

The lender was a profit participant, usually on a percentage basis, and upon the sale of the project perhaps realized an equity kicker.

The funds for all or a material portion of these loans were obtained from brokered or jumbo savings. In one case, a large State-chartered institution loaned $700 million for construction projects with the aforementioned high-risk characteristics, which were funded by wholesale funds. Of this aggregate total, 70 percent are currently scheduled items or nonperforming assets.

There are currently 8 California thrift institutions which are FSLIC cases and 10 which are projected to be FSLIC cases within 12 months. Of these institutions, at least 15 may be cited for asset quality problems. Most entered into transactions involving speculative construction and real estate development projects which

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shared the same high-risk characteristics as those described above in the discussion of poor lending practices committed by Texas thrifts. These institutions, like those in Texas, also placed considerable reliance upon brokered or jumbo savings to fund their projects.

The cost to FSLIC to resolve these cases is running from 10 to 20 percent of association assets. The current California FSLIC cases total $9.7 billion in assets. Those foreseen as FSLIC cases within 12 months total $3.5 billion in assets.

Potential loss exposure to the FSLIC fund from abuses of direct investment authority from other institutions, yet to be identified, are more difficult to estimate. This is due to an inability to analyze asset quality and to properly recognize income offsite. Experience has shown that the true extent of a problem doesn't usually come to light until an examination team can be sent in to review the association's lending practices and bookkeeping. Due to staffing shortages, the Board, to date, has been unable to provide examination reviews on as timely a basis as is needed.

MERGER COULD BE THE DEMISE OF S&L'S

Senator RIEGLE. Given the pressures of time, I want to move to another area, although I'd like to talk further on the subject we've just been on, but on the issue of Chairman Isaac's suggestion that the FDIC and the FSLIC be merged, I know you tend not to support that and is it your thought that if we were to do that—some have advanced the view that that might just be starting us down the road toward the ultimate elimination of the savings and loan industry as we think about it. Do you see it in those terms?

Mr. GRAY. Yes, I do, absolutely. I also think that this is presented as an instant panacea for problems. It is not a panacea for problems. We still have the same number of problems. The way to get at this problem is to face up to it and deal with it. I think the fund certainly has a chance to work itself out of its problems over time. I'm not going to say how much time that is because, as I suggested before, it's in part a cash flow problem.

In one way or the other, we have to deal with this. There's no question about that. But it also seems to me that it doesn't solve anything to take away the incentive that problems create for reform and just summarily say we're going to turn all these problems over to the FDIC.

Senator RIEGLE. But then, to make sure I understand you correctly, you would share the concern that there are those that would like to see the savings and loan industry disappear anyway.

Mr. GRAY. That is very true.

Senator RIEGLE. They're not convinced that it has a residual purpose and it could be folded into some sort of a more homogeneous financial services system in the country.

Mr. GRAY. That's right.

Senator RIEGLE. But I gather that you feel that if the FSLIC system were merged with the FDIC that that would accelerate the potential that the savings and loan industry might start to disappear?

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Mr. GRAY. Sure. As I suggested in my overview statement, the moment that happened, the FDIC would be up here saying, "Now that we insure these institutions, we're going to supervise them. We're going to examine them." They would be demanding that. And I have never detected on the part of people at the FDIC a particular sympathy for the role that thrifts play. I don't think that would be an overstatement.

Senator RIEGLE. Just one other thing quickly. That is, we've seen the situations in Ohio and Maryland and we do have other State systems with State insurance programs. I'm concerned about that and I'm concerned that we may not have seen the end of the problems and that there may be other State difficulties arising. And I'm not going to name a particular State because that would help create the problem, but I'm hearing and sensing a concern that this may jump to a new place soon.

I'm wondering, without getting into the names of States, do you have some concern along these lines and what might we do?

Mr. GRAY. About these so-called private insurance funds?

Senator RIEGLE. Yes, in the remaining States that have them.

Mr. GRAY. Well, I think you're seeing a de facto move to Federal deposit insurance. We have worked closely with the State of Ohio and the State of Maryland in a very cooperative effort. I believe that we have now granted conditional approval for FSLIC insurance for some 24 members of a private North Carolina fund. We have had applications from some Massachusetts cooperative banks, and I think there's a natural de facto movement away from this.

Senator RIEGLE. Is that going to be sufficient? What I'm concerned about and what we're seeing in the other States and what we're seeing in Maryland is that as it sorts out you have two broad categories. You have institutions that are reasonably sound and they can come in and qualify, and then you have those that are not and are not qualifying and so they're still hanging out there. And I would think the same is true in other States, that for the same reasons, if you had a test case start to develop, that you would have the same two categories. You would have some institutions that are sound and would qualify and you're indicating that some in those States are coming forward, but by the same token, you would have some of the others that would not and could trigger the problem.

I'm wondering if there's a way to head that off?

Mr. GRAY. Well, first of all, in Massachusetts, as an example, and I believe in Pennsylvania, we have not detected any particular problem that would be of the kind that we experienced in Ohio and Maryland, but we see this de facto movement occurring anyway because I think some institutions have seen the value of moving to de facto Federal insurance.

Senator RIEGLE. Is there any State unnamed in which we are seeing any pickup in activity?

Mr. GRAY. No, other than Maryland and Ohio, not that I'm aware of, Senator.

Senator RIEGLE. My time is up. I thank you for your responses.

Mr. GRAY. You're welcome.

The CHAIRMAN. Senator Sasser.

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Senator SASSER. Mr. Chairman, I may have one or two questions of Mr. Gray and in the interest of time I'll just submit them for the record.

The CHAIRMAN. Thank you very much, Senator.

Thank you, Chairman Gray. We appreciate your being here today.

Mr. GRAY. Thank you, Mr. Chairman.

[Response to written questions of Senator Garn, Armstrong, Gramm, Cranston, and Sasser follow:]

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Federal Home Loan Bank Board

EDWIN J. GRAY
CHAIRMAN

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

January 2, 1986

Question 1 (Senator Garn)

1. What is your view of the National Council Task Force's proposal for risk-based net worth and a definitive time frame for an institution to come into compliance, or find a merger partner, or be placed into receivership?

Answer:

The National Council Task Force's proposal for risk-based net worth would calculate an institution's net-worth requirement based on an institution's past behavior and a multitude of other factors. Such a rating scheme would be difficult to establish and to maintain. We at the Bank Board have rejected this conceptual approach for determining capital requirements. We are concerned that such an approach would be self-defeating because it would require the highest capital levels for those institutions least able to raise capital. Furthermore, it would base capital requirements on past behavior and not on future potential performance. As such, it fails to provide an incentive to avoid excess risk.

The Bank Board's proposal for supplementary premiums for those activities that go beyond those authorized by Garn-St Germain does provide the necessary incentives. In addition, the premiums are reduced as an institution increases its net worth. This type of supplementary premium encourages institutions to structure their balance sheet so as to limit their insurance premiums and ultimately their risk exposure.

The Task Force's time table for an institution to come into compliance, find a merger partner, or be placed into receivership is overly restrictive. Effectively allowing the FSLIC only 90 days to find a merger partner for an institution which is predicted to be 12 months from insolvency could result in eliminating a least-cost method of resolving an institution's problems. While the Bank Board agrees that a timely resolution of problem institutions is appropriate, we do not favor specifying the exact time limitations. Such a constraint may actually serve to increase the costs to the FSLIC.

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Question 2 (Senator Garn)

2. With regard to the proposed asset management subsidiary, is the real advantage the ability to manage problem assets outside the ceiling of federal pay caps? Isn't a disadvantage that the value of such assets would decline if they had to be disposed of on a stand alone basis - as opposed to being in a package of good assets and solid customers to be sold as a going concern? What are the pros and cons of one asset management subsidiary versus twelve?

Answer:

A great advantage to an asset management subsidiary is the ability to develop a first rate organization which can operate much as a private sector entity to deal rapidly and effectively with an enormous quantity and complex variety of assets scattered around the United States. Federal pay caps, limits on numbers of personnel, contracting limitations and other constraints frustrate the development of this capability within the Federal Savings and Loan Insurance Corporation ("FSLIC") itself.

The use of this kind of subsidiary would not mandate that any assets be disposed of on a stand alone basis. The ability of FSLIC to package assets and/or sell failed institutions as a going concern to obtain the most profitable results for FSLIC would not be affected. The subsidiary would provide an additional management and disposition tool, but would not detract from the ability of FSLIC to use management and disposition techniques now available to it.

We see no advantage in creating twelve asset management subsidiaries. A single subsidiary can obtain the best management personnel available and could operate regional offices as required by operating needs from time to time. The proposal to create twelve separate subsidiaries in the twelve Federal Home Loan Bank Districts is flawed in that many of the Bank Districts have few problem assets, leaving no real need for a subsidiary located in the District and in that a division of available management talent would tremendously dilute the effectiveness of the operation. The ability to manage assets on a local basis exists in the creation of regional offices of a single subsidiary wherever there is need for such an office.

Aside from examination and supervision, many functions are still retained in Washington. This includes rulemaking, adjudication of quasi judicial cases, management of enforcement actions, litigation involving the Board and FSLIC, the Board's securities jurisdiction and the approval of applications for de novo charters and other applications involving novel or policy questions.

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Question 3 (Senator Garn)

If a substantial amount of the Home Loan Banks' assets consisted of loans to the FSLIC, could this severely lessen the willingness of the private sector to invest in a Home Loan Bank's debt instruments? Why or why not? Currently what is the total excess debt capacity of the regional Home Loan Banks?

Answer:

Broad market acceptance of FHLB consolidate obligations reflects both the actual and perceived credit risk associated with the System. Actual credit risk is a function of many things. Among the most critical are capitalization, liquidity, asset quality, profitability and sound management. To date, investors recognize the soundness of our System given these criteria. The Federal Home Loan Banks have a 9% equity ratio, with approximately $9.8 billion in capital stock and retained earnings. Cash and investments hover between $13 and $15 billion. Lending standards are well maintained and the value of the collateral remains good. Advances are over-collateralized and vary from District Bank to District Bank, but range from 110% to 200% of the amount of an advance, depending on the frequency with which the collateral is marked to market. On a Systemwide basis, there is a broad distribution of loan exposure among several entities. Although earnings have varied throughout the past several years, since 1980 the System has returned from 6.9% to 13% on equity and .72% to 1.2% on assets. For the first 9 months of 1985, the System has earned $772 million dollars. Because each federal agency (Farm Credit, FNMA, FHLBanks) is now being scrutinized on its own merit, investors would regard an expansion of loans to FSLIC as requiring a corresponding expansion of the Banks' capital.

In response to the question of excess debt capacity, one must be sensitive to various interpretations of what is meant by the term "excess debt capacity." Certainly, limiting parameters include the condition of financial markets at any point in time, the public's perception of Federal Home Loan Loan Bank credit, and the amount of FHLBank debt the private sector is willing to purchase and hold. However, if these market constraints are ignored one can define "excess debt capacity" as the amount of additional debt that could be raised without exceeding one of two statutory ceilings. The General Regulations of the Bank Board restrict issuance of consolidated obligations to a maximum of 12 times paid-in capital stock and reserves under Section 16 of the Federal Home Loan Bank Act, as amended. Additionally, the Banks are required to maintain the following types of assets, free from any lien or pledge, in an amount equal to at least the amount of consolidated obligations outstanding: (a) cash, (b) obligations of or fully guaranteed by the United States, (c) secured advances, and (d) mortgages as to which one or more Federal Home Loan Banks have any guaranty or insurance or commitment therefore, by the United States or any agency thereof. Using the first parameter, the additional debt capacity over an extended period of time is approximately $35 billion, and collateral requirements further restrict that amount to about $25 billion.

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Question 4 (Senator Garn)

At what point would loans from the Federal Home Loan Banks begin to impair the confidence of the private sector investors in the Home Loan Banks' debt obligations?

Answer:

It is very difficult to pinpoint the level of concentration which would cause investors to shy away from FHLB credit. Currently, the FHLBanks have direct exposure in the amount of $900 million fully secured loans to FSLIC and indirect exposure of approximately $2.4 billion in fully secured loans to members which are guaranteed by FSLIC. As discussed earlier, whether substantive or not, perceptions regarding actual exposure coupled with heightened uncertainty as to the amount of future exposure may cause investors to pull away at any time. Evaluation of risk includes all types of exposure: direct and secured, direct and unsecured, and indirect exposure relating to collateralized loans made which bear a FSLIC guaranty. All are evaluated regarding potential impairment of FHLB capital position and earnings ability.

Absent any change in underlying capital, prudent lending would suggest that fully secured exposure would be limited to 5% of assets or approximately $5 billion currently and that unsecured lending would be limited to 10% of capital or slightly less than $1 billion.

Question 5

The primary supervision of thrifts has already been delegated to the local Federal Home Loan Banks. If the disposition of problem institutions were also delegated to the local banks, what would be left for the Bank Board? Wouldn't there be a danger of the Bank Board losing control?

Answer:

Although examination and supervision of thrifts on a local level has been delegated to the Federal Home Loan Banks, the Federal Home Loan Bank Board has retained at the Board an Office of Examinations and Supervision which oversees supervisors and examiners and which relates Bank Board policy to the regional districts. Thus, the regional supervisors report to the Bank Board which then reports to the Congress on its uniform policy decisions and the effectiveness of local examination and supervision.

Where disposition of problem institutions is delegated to the local Banks, actual transactions and policy determinations are approved by the Board itself. There is no danger of the Bank Board losing control so long as it maintains an effective reporting and oversight mechanism. The Board's Washington, staff is familiar with local operations and constantly advises the Board on individual cases and on broad policy matters.

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Question 6 (Senator Garn)

Should the FSLIC require its insureds to make a one percent deposit in the fund? Why or why not?

Answer:

The FSLIC presently has statutory authority to require its insured institutions to make a deposit of up to one percent of the accounts. However, the authority of FSLIC to use such a deposit to meet its expenses and losses is not clear. The Board has not taken any position on whether such a deposit should be required.

Question 7 (Senator Garn):

If the FSLIC and the FDIC funds are not merged, where will the FSLIC obtain sufficient funds to deal with its problems over time?

Answer:

A merger of the FSLIC and FDIC insurance funds makes no financial sense. It would not reduce the cost of resolving the bad asset problem cases which are by far the most expensive on the FSLIC's docket and it would not, from a public policy view, provide any additional resources to the federal deposit insurance system. The FDIC is not without serious potential problems of its own. Again, the current FSLIC caseload primarily consists of institutions experiencing asset quality problems. We would expect that a similar condition exists within the commercial banking sector, especially in the energy and agricultural lending areas. The commercial banking sector also is saddled with a sizeable portfolio of foreign loans that may go sour. Given these factors, it is the Board's view that no benefit would result from merging the FDIC and FSLIC funds.

The FSLIC fund is supported by the collection of premium payments from member institutions and from income generated on investments. The insurance reserves were $6,607,161,000 as of July 31, 1985. The reserve has two components, the primary reserve ($5,852,206,000) and the secondary reserve ($754,955,000). The secondary reserve consists of special premium payments and must eventually be paid back to the contributing member institution unless the primary reserve is insufficient to meet FSLIC's losses.

Premium Income - Members must pay an annual cash premium to the FSLIC equal to 1/12 of 1 per centum of member insured and uninsured deposits.

To recoup losses of the FSLIC, additional premiums may be assessed by FSLIC, not exceeding 1/8 of 1 per centum of member insured and uninsured deposits in any year. The Board assessed three special premiums for the first three quarters of 1985 each amounting to 1/32 of one per centum of deposits. These three assessments totaled $751,115,401 with an annualized estimate of over $1 billion per year. We project that income from premium payments will be $1.89 billion for 1986 and $2.08 billion in 1987 if the special assessment of 1/8th of 1% is continued.

Investment Income - As of July 31, 1985 the FSLIC's investment portfolio totalled $6,090,809,000 consisting mostly of Treasury obligations. The returns on the investment portfolio recently have approximated 7.5 percent, or about $455 million per year.

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Lines of Credit

The FSLIC has the capability to draw upon lines of credit with the member institutions, the Federal Home Loan Banks and the U.S. Treasury should additional liquidity be required to meet operating needs of the FSLIC.

From Members - At any time, the Board may require that members deposit cash with the FSLIC. The aggregate total of any such deposits may not exceed one per centum of member's insured deposits, but members may be required to maintain the deposit at any level equal to or below one per centum. The FSLIC must pay interest on the deposit equal to the average rate of return the FSLIC receives from its investments in government securities. There is no prescribed time limit for return of this deposit to members. This line of credit, which has never been utilized, could produce over $8 billion to the FSLIC.

From the Federal Home Loan Banks (FHLB's) - The FSLIC may borrow from any of the twelve Federal Home Loan Banks, limited by the financial capacity of the Banks and the willingness of each of their Boards of Directors to authorize funds to FSLIC. The FHLB's are well capitalized, at nearly $9 billion. They are able to borrow money in the public money markets at rates just slightly above Treasury rates. To date, the FSLIC has borrowed $900 million dollars from the FHLB's which has been passed through FSLIC in collateralized loans from which the FSLIC expects to experience no financial losses. Given a prudent expansion of the Banks' capital base over an extended period of time of five (5) years, for example, this device could provide the FSLIC with up to five (5) billion dollars.

From the U.S. Treasury - FSLIC has a direct line of credit from the U.S. Treasury in the amount of $750 million dollars. This line was established by legislation in June, 1950 and has never been used. Utilization of this line of credit could send a signal whose potential adverse effects could undermine public confidence in the nation's financial system.

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FSLIC Sources of Funds Summary

(000's omitted)

Reserves	
$5,852,206	Primary Reserve 7/31/85
$754,955	Secondary Reserve 7/31/85
Income (Annual)	
$757,000	Estimated annual income from regular premiums
$1,136,000	Estimated income from additional premiums
$510,000	Estimated annual investment income
$40,000	Miscellaneous income
Borrowing Authority [1]	
$8,222,810	Estimated size of 1% deposit as of 7/31/85
$5,000,000	Estimated FHLB public borrowings, passed-through to the FSLIC (assuming an extended period of approximately 5 years during which the borrowings would occur)

[1] In addition to the borrowing authority listed above, the FSLIC could access the following amounts:

----Seven hundred and fifty million dollars ($750,000,000) - FSLIC line of credit with the U.S. Treasury; and,

----Four billion dollars ($4,000,000,000) - FHLB line of credit with the U.S. Treasury passed-through FSLIC for secured loans to member institutions.

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Projection of Cumulative Income and Borrowing Authority

(5 Year Estimates)

(000's omitted)

Income

$3,785,000	Estimated 5 years income from regular premiums
$5,680,000	Estimated 5 year income from additional premiums (if the Board exercised this authority for a 5 year term)
$2,550,000	Estimated 5 year investment income
$200,000	Estimated miscellaneous income

Borrowing Authority [2]

$8,222,810	Estimated size of 1% deposit as of 7/31/85
$5,000,000	Estimated FHLB public borrowings, passed-through to the FSLIC (assuming an extended period of approximately 5 years over which the borrowings would occur)

[2] The amounts listed in note 1, above, also apply here.

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Question 8 (Senator Garn):

With regard to other forms of market discipline by uninsured depositors and general creditors, it is argued that the market discipline is fickle, is trendy. Indeed, it is argued that a run is the ultimate form of market discipline. How do you respond to these concerns?

Answer:

Runs on an institution represent a malfunction of depositor confidence. To the extent that deposits are 100 percent insured by the Federal Government, no depositor need lose confidence and withdraw their funds simply because of unfavorable news. Coupled with this deposit stability, however, is the complete lack of motivation for depositors to monitor the riskiness of the depository institution. As a result, deposit stability is obtained at the expense of market discipline.

To the extent their deposits are not insured, those depositors may choose to withdraw their funds if they believe circumstances appear to warrant withdrawals. Thus, an increase in market discipline is obtained only at the expense of the reduced stability of an insured institution.

No one knows the exact level at which the benefits from increased market discipline are overcome by the increased cost of financial instability. However, the appropriateness of reducing insurance coverage and increasing market discipline clearly rests on balancing these costs and benefits.

Question 9 (Senator Garn)

Should the FLSIC be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed bank with any profit after administrative costs arising from the transaction returned to the original stockholders?

Answer:

This is a policy that should be implemented, when practicable. This policy has been implemented to some extent under existing statutes, in those cases in which an association is taken over not because of insolvency, but because it has dissipated substantial assets in earnings arising from a violation of law or unsound practice, or because it is in an unsafe or unsound condition to transact business. In these latter circumstances, however, it is likely as a practical matter that such an association is actually insolvent or irreversibly declining toward insolvency even if not reporting that condition. For the FSLIC to force a merger or acquisition upon an association at a point prior to irreversible decline, absent the factors cited above, would require new legislation.

Question 10 (Senator Garn)

If the burden of mismanagement was placed squarely and directly on the managers and stockholders, is it necessary to punish depositors and borrowers in order to achieve an improved supervisory system? If failures were handled through a purchase and assumption or forced merger at an earlier state, regardless of size, wouldn't this dispose of the fairness question as it relates to large and small institutions?

Answer:

It is and has been the policy of the Board to avoid the failure of an insured institution by the merger of the institution or the purchase of its assets and assumption of its liabilities, provided that the cost and risk to the FSLIC are reduced substantially by such an acquisition. In almost every case, if the cost or potential cost of such an acquisition is in excess of that reasonably necessary to save the FSLIC the cost of liquidating the institution, the Board cannot under its governing statute make the findings necessary to authorize the transaction. We have been faced increasingly with situations in which an association's acquisition would cost the FSLIC more than it would lose in a liquidation accompanied by the payment of insurance, or in which there are no buyers whatsoever for the association.

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Question 11 (Senator Garn)

11. In your opinion, what are the advantages and disadvantages of risk-based capital and risk-based premiums? Should we consider one or the other or both?

Answer:

11. It is apparent from the number of proposals currently circulating that the concepts of risk-based premiums and risk-based capital can be interpreted and applied in various ways. However, regardless of the specific application, the fundamental motivation underlying these concepts is to force depository institutions to realize the full economic cost of the risks they choose to take. With either risk-based capital or risk-based premiums, institutions must include in their decision-making procedure the cost of excess risk taking. This clearly has advantages over the current system that does not impose such a requirement.

One advantage of risk-based capital requirements is that they increase the amount of private resources that are at risk. By reducing the extent to which an institution can be leveraged, risk-based capital requirements provide an added buffer for the insurance agency. Furthermore, since raising capital is not a costless endeavor, institutions must weigh the benefits of increased risk-taking against the added cost of additional capital. This clearly imposes limits on the amount of profitable risk-taking an institution is able to undertake.

Risk-based premiums also raise the cost of increased risk-taking. An institution seeking to fund a risky endeavor would have to consider not only the explicit cost of funds but also the added premiums that would result from the additional risk in the portfolio. Furthermore, risk-based premiums can generate increased resources for the insuring agency's fund. These resources would then be available to absorb losses in the event of a failure.

The obvious disadvantage with both of these concepts is that they require the insurer to be able to measure risk accurately. Furthermore, the insurer must be able to determine the reaction of an institution to a change in premiums or capital levels. Only if the insurer can both measure risk and predict reactions will it be able to apply these concepts in practice.

The Bank Board's proposal incorporates both the concept of risk-based premiums and risk-based capital. First, it allows the insurer to levy a supplementary premium for those activities that go beyond what Congress, in the Garn-St Germain Act, determined were suitable for thrifts. This supplementary premium would be based on the risk of loss such additional activities generate for the FSLIC. Additionally, the Board's proposal requires the insurer to take into consideration the net-worth level of an institution. Using a sliding scale, the supplementary-risk premium would be priced lower, the higher the institution's net worth.

To assist in the accurate pricing of these supplementary premiums, the Bank Board has contracted a private firm to provide recommendations. We believe that the private sector, with its actuarial and insurance expertise, is the most appropriate source for the Bank Board to obtain impartial and objective risk-pricing recommendations. These will then be modified and updated as new information becomes available.

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Question 12 (Senator Garn)

12. There appears to be strong support for risk-based capital in some form. Some suggest an adoption of risk-based capital by the federal insurance agencies would give them the necessary authorities to regulate the activities of state-chartered institutions without granting the authority to override a state legislature. What is your view?

Answer:

As noted in our reply to Question 11, the Board's legislative proposal incorporates a risk-based capital component. If enacted, the Board's supplementary risk-based premium would work in tandem with current regulations which also acknowledge the importance of differential capital to reflect varying levels of risk.

In January of this year, the Bank Board adopted a rule limiting the extent to which a federally insured thrift could engage in direct investment without supervisory approval. In addition, the Bank Board revised its method for calculating net-worth requirements so as to explicitly include a contingency factor based on the amount of direct investment by an institution. Both of these actions were motivated by the need to protect the FSLIC insurance fund from the additional risk generated by the various activities authorized by state legislatures. Clearly, to the extent that state legislatures permit their respective institutions to engage in activities which generate increased risk exposure for the insuring agency, the insurer needs the ability to impose differential capital requirements.

These risk-based capital standards merely reflect the additional risk these institutions are forcing the insurer to bear. Furthermore, the ability to establish risk-based capital requirements allows the insurer to protect the integrity of the insurance fund without necessitating an override of a state legislature's decision.

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Question #13 (Senator Garn)

How would you recommend resolving the dilemma to the dual banking system created by states authorizing activities whic' place the federal insurance agencies at risk?

Answer:

The Federal Home Loan Bank Board believes that there are inherent structural deficiencies in our Federal Insurance System which requires the FSLIC to insure the deposits of state chartered institutions which can be invested in a wide array of activities, well beyond those allowed for Federally chartered institutions. We, therefore, feel that the insurance premium structure needs to be revamped so that institutions investing in riskier assets pay a larger share of the total insurance premium. The Bank Board has submitted proposed legislation that would allow the FSLIC to assess premiums based on various classes of assets and net worth levels. We believe this proposal is practical and workable, as it builds on the existing statutory framework for FSLIC insurance, which Congress recognized as appropriate for a range of activities suitable for federal associations in the Garn-St Germain Act of 1982. Under the Board's proposal, supplementary premiums would be required only for investments of a kind, or to a degree, not authorized for federal associations. The premium structure under this revised system could be adjusted on an ongoing basis to take into effect actual losses incurred by the FSLIC in these various classes of assets.

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Question 14 (Senator Garn)

14. Do you believe that the FHLBB and/or FSLIC need increased enforcement authority? If so, in what areas?

Answer:

The Bank Board believes that increased enforcement authority would improve its ability to respond quickly and effectively to serious problems in the thrift industry. The legislative proposals that we presented to your committee last spring (S.759) reflect the changes we feel are necessary for our enforcement authority. These proposals are clarifications of present authority designed to enable more timely action to halt regulatory violations and unsafe or unsound practices.

The Bank Board received its administrative enforcement authority in 1966 at the same time the banking agencies received identical authority. These provisions have been modified in a meaningful way only twice in the nearly 20 years since they were enacted, and the same modifications, with few exceptions, were also granted to the other four financial institutions regulatory agencies in the same form. The logistics of amending in an identical fashion, the statutory language for five regulatory agencies and five sets of financial institutions, each with its own trade organizations and spokespersons, is nearly impossible.

While identical statutory language may have seemed logical to lawmakers in the past, the Bank Board believes that many of its present supervisory concerns are unique to thrift institutions, and there is an urgent need to address these problems now. The proposals in the Bank Board's legislation are based on real problems encountered in supervisory cases where effective enforcement actions were delayed or unable to be brought at all because of statutory restrictions.

The most important provisions of our proposed enforcement amendments are the changes to our authority to issue temporary cease and desist orders. At the present time, a temporary order that is effective immediately may be issued only when the alleged violation or unsound practice charged in the Notice of Charges and Hearing is likely to cause insolvency, a substantial dissipation of assets or earnings, or a serious weakening of the financial condition of the institution. Because our statute allows an institution or individual served with such an order to challenge the temporary order within ten days in U.S. District Court, the Bank Board cannot simply state that the violation is one that <u>may</u> produce serious losses, it must stand ready to prove those losses in Court at the time it serves a temporary order on an institution. This means that valuable time is lost while the Board is gathering proof of insolvency or substantial losses, even though we know that a serious problem exists at an

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institution. To combat this, the proposed amendments would remove the modifiers of "substantial" and "serious" before the finding of "loss" in such emergency cases.

Also proposed for our temporary cease and desist authority is a new provision to enable us to issue a temporary order to halt an institution's making of new loans or investments whenever we are unable, despite the reasonable efforts of our examiners, to determine the true financial condition of an institution because of the disarray or lack of books and records. Deficient record-keeping has been a recurring theme in the more serious thrift failures over the last two years. It is an unfortunate by-product of the cycle of excessively rapid growth of savings deposits and the rush to place those deposits into high risk loans. Often, the same developers and speculators who are willing to pay exorbitant fees and to commit to high interest rates are those who fail to complete applications, who do not produce adequate financial information about themselves or their proposed projects, and who are unable to produce an acceptable appraisal report. The proposed legislation would enable the Board to halt new lending until an association's books and records are in an acceptable condition.

To supplement its temporary cease-and-desist authority, the Bank Board also is seeking the power to apply for injunctive relief in U.S. District Court whenever it determines that its administrative enforcement powers are insufficient to resolve serious statutory or regulatory violations or unsafe and unsound practices.

The Bank Board also is proposing to close loopholes and clarify statutory language in its existing cease-and-desist authority, such as by stating clearly that the agency may bring enforcement actions against second-tier and partly-owned subsidiaries of insured institutions, including those that are wholly-owned by several thrifts. The amendments proposed also would clarify that the Board has the power, at the conclusion of cease-and-desist proceedings, to order affirmative corrective action such as restitution, rescission, the disposal of loans, and guarantees against loss, in order to correct the conditions resulting from regulatory violations or unsound practices.

Several changes to the Bank Board's removal and prohibition powers also have been proposed to make this authority more practical as well. It often has been said that the grounds to remove a banker or thrift official from office are stiffer than those required to convict him of a criminal offense. In many cases, this is absolutely true. Despite our strong desire to make it easier to remove the negligent or wrongdoing thrift official, we understand the need to preserve due process rights of individuals and have proposed only modest changes to our removal statute. These include: (1) a clarification of who may be removed and/or prohibited as well as when the action may be brought, to avoid claims that the agency loses jurisdiction when a person resigns

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before a removal action is completed; (2) a removal of the modifier of "substantial" before the finding of financial loss to an institution in the second ground for maintaining a removal case; (3) a recognition that harm to stockholders as well as to members should be considered in removal cases; and (4) a change that makes the grounds to remove an official from a second institution for misconduct at another institution the same as the grounds for a direct removal from the first institution.

In addition, the Board has proposed to extend the industry-wide ban that presently exists for individuals who have been removed. At the present time, a thrift official removed from one FSLIC-insured institution may not serve as a director, officer, or employee of another FSLIC-insured institution, although he may work for an FDIC-insured bank or a NCUA-insured credit union without penalty. The Board's legislation would make one who has been removed by an agency ineligible for reemployment by any type of insured financial institution without the prior approval of the appropriate regulatory agency.

Finally, the Board is proposing to clarify the reach of all of its enforcement tools by specifying in new definitions the institutions and individuals who may be subject to administrative enforcement proceedings, and by inserting a statutory definition for unsafe or unsound practice, which is "any action or omission, which is, in the opinion of the Corporation, contrary to generally accepted standards of prudent operation, whether relating to the institution's internal management or to any external matter, the possible consequence of which, if continued, may be abnormal risk or loss or other damage to an insured institution or any subsidiary thereof, to its stockholders or accountholders, or to the Corporation."

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Question 15 (Senator Garn)

Does the Community Savings and Loan an EPIC problem reinforce the need for certain activities to be engage through a subsidiary of the holding company rather than a subsidiary of a depository institution?

Answer:

The fact that EPIC companies were held as subsidiaries of Community is not the explanation of the problem that EPIC presented to Community. The key rather was the role of Community in providing financing in connection with the EPIC family of companies and the partnerships being promoted. Without adequate safeguards such as prudent loan-to-value ratios, limits on loans to one borrower, and restrictions on transactions with affiliates -- and compliance and enforcement of those safeguards -- an institution can become over-extended, whether the entity being financed is a subsidiary of the institution or an affiliate of the institution's holding company.

The regulations of the Board implement safeguards of the type just described. In addition, the Board's direct investment regulation requires a special review by the Board's supervision staff when the amount of an institution's direct investments in real estate, certain equity securities and service corporations exceed specified levels. As a state-chartered, state-insured institution, however, Community was subject to none of the protections applicable to federally chartered or federally-insured institutions.

The Board believes that its regulatory provisions contain the key types of safeguards that enable service corporations to function as valuable structural options for prudent diversification. In particular, service corporations of federally chartered thrifts traditionally have been important contributors to thrifts' profitability. Whether to diversify through a subsidiary -- subject to safeguards -- or through a holding company affiliate is a choice of options best left to an institution's management to make in view of all the facts and circumstances of each individual situation. Rather than directing such a choice, the Board believes that prudent safeguards and risk based insurance premiums are a more appropriate response.

Question 16 (Senator Garn):

How can or should we determine if the size of the insurance fund is sufficient and will continue to be sufficient to assure confidence and manage the costs of potential failures?

Answer:

The FSLIC insurance fund is of sufficient size to manage the costs of near-term potential failures. Whether the size is adequate to manage the total costs of all potential failures depends on three major variables:

a. FSLIC's income stream net of overhead expenses.

b. Total costs to FSLIC of potential failures.

c. The timing of costs recognition on FSLIC's books.

FSLIC's total income stream is relatively predictable and is legislatively limited to an annual maximum of 5/24 of 1% of total deposits. As deposits grow, annual income grows proportionately. Total costs are less easy to predict, and it is unclear at this time how large the total cost problem is. Most probably, its size exceeds FSLIC's annual income and may exceed the size of FSLIC's reserves. If the timing of cost recognition is such that annual cost recognition does not exceed annual income, reserves will not shrink and the problem can be absorbed over time. Uncontrolled and sudden cost recognition could severely stress the fund and its income stream, and possibly damage public confidence. It is important that FSLIC's cost estimates, projections, and sets of related assumptions be treated carefully and confidentially. We intend to work within the administration and with the Congress to confidentially, but candidly discuss and assess the various cost estimates and their assumption sets, and to manage the costs of potential failures in as controlled a manner as possible, thereby minimizing the total costs of case resolutions. To the degree that total costs can be brought into focus over time, the overall question of fund adequacy can be reassessed and the necessary tactical adjustments made.

Close cooperation with the Congress is seen as an absolute necessity, as public confidence in federally insured depository institutions rests primarily on the full faith and credit of the U.S. Government that is implicit in the concept of federally backed deposit insurance. The absolute size of FSLIC reserves and its income stream are important to the public, but pales by comparison to its trust in the government's capability to create a stable financial system.

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Question 17a. Are there any provisions in the proposed tax legislation which would have an adverse effect on savings and loans? On potential savings and loan mergers?

There are several provisions in the proposed tax legislation which would have an adverse effect on savings and loan institutions. A short summary of the adverse effects of these provisions is provided below, and a longer explanation of the Board's position is contained in the attached material:

1. Letter dated October 10, 1985, from all members of the Bank Board to Chairman Dan Rostenkowski, House Ways and Means Committee.

2. Current economic conditions of weak savings and loans.

3. Letter dated May 6, 1985, from all members of the Bank Board to James A. Baker, III, Secretary of the Treasury.

4. Letter dated June 18, 1985, from the Department of the Treasury to Donald I. Hovde, Board Member.

Three provisions in the proposed legislation would be detrimental for thrift institutions:

1. The proposal to recapture the past bad debt deductions accumulated by thrift institutions. This would eliminate 40% of the industry's GAAP net worth on a balance-sheet basis. Further, a thrift would be required to put into its income stream these past deductions and become liable to pay tax on this non-cash income.

2. Thrifts would lose the present bad debt deduction for 40 percent of taxable income. A specific charge-off method would be used. The effective tax rate of thrifts would increase from its current 31.2 percent to the proposed maximum corporate tax rate of 33 percent.

3. The special rules for net operating losses for depository institutions would be repealed. The general corporate rules of 3-year carryback and 15-year carryforward would apply. The effective date of this proposal is January 1, 1986. As a result, the large losses suffered by thrifts in the 1980-1984 period will not get the benefit of the longer carryover proposed.

Federal Home Loan Bank Board

1700 G Street N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

October 10, 1985

The Honorable Dan Rostenkowski
Chairman
House Ways and Means Committee
2111 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Rostenkowski:

This letter addresses your proposal to terminate, as of January 1, 1986, the tax provisions which facilitate supervisory mergers of insolvent savings and loan associations.1/

The President has advocated continuing these provisions through December 31, 1990. He recognizes that "the thrift industry has not fully recovered from the economic conditions which prompted Congress to enact the special reorganization rules in 1981." We agree with this appraisal and strongly support the President's proposal. We urge you to retain it in your plan.

These provisions are vitally important to the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation (FSLIC). Termination of the FSLIC rules could not come at a worse time. In our opinion as regulators, your proposal will devastate the weak elements of the thrift industry and further jeopardize the FSLIC insurance fund.

On May 6, 1985, the Board expressed its concern to Secretary Baker. A copy of this letter, and a copy of his office's response, are attached.

Supervisory mergers allow the Board to resolve problem cases at costs significantly less than the cost of liquidation and with minimum disruption to depositors. Your proposal would eliminate potential acquirers willing to work with the Board on supervisory transactions. A drastic increase in liquidations of defaulted institutions would place the insurance fund under more critical stress than it already faces.

1/These provisions are section 368(a)(3)(D)(ii), section 382(b)(7)(B), section 597, and part of section 593(e).

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Despite recent moderation of interest rates, the challenge to the adequacy of the FSLIC fund has never been greater. This is true even without taking your proposals into account. We are faced with the challenge of finding solutions to asset quality problems of many of our supervisory cases. An Attachment supplies details on FSLIC assistance cases and estimated costs for 1985 and 1986.

We cannot afford at this time to create new and unnecessary obstacles to these efforts from the tax side -- especially since the FSLIC provisions are part of existing law and have worked well without abuse.

We also urge that your amendment dealing with Section 265(1) of the Code be included in the continuation of these provisions.

The huge losses in the industry's recent past must be an essential element of the ongoing restructuring process. For this reason, we believe that your proposal to lengthen the loss carryover period for thrifts should apply to losses suffered during the 1980-1985 period. Recapture of past bad debt reserves should also be avoided because the effect is to reduce the industry's net worth. Financial net worth levels have serious consequences from our prospective as regulators. Reduced net worth will cause the weaker institutions to become even more fragile. The relatively stronger pool of acquirers will become weaker, and as a consequence, they will be less able financially to become merger partners under our requirements.

We, or any member of our staff, would be happy to meet with you or your staff to discuss our concerns in detail.

Sincerely,

Edwin B. Gray
Chairman

Donald I. Hovde
Board Member

Mary A. Grigsby
Board Member

Attachment

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ATTACHMENT

CURRENT ECONOMIC CONDITIONS

With regard to the thrift industry's current condition, we emphasize the magnitude of the task facing FSLIC. Recent interest rate declines have reduced the negative "spread" between the industry's cost of funds and yield on assets, which accounted for the record losses experienced by the industry in 1981 and 1982. The crisis, however, is by no means over, and FSLIC's need for maximum cost efficiencies continues. The cumulative impact of several years of record losses has seriously eroded the capital base of the industry and has left many associations so weakened that they will continue to deteriorate regardless of further positive economic developments.

Although thrift institutions significantly increased their already large contribution to housing markets during 1984, developments during last year demonstrated the fragility of the industry's recovery, and its vulnerability to interest rate changes during the lengthy period required to restructure thrifts' balance sheets. In recent years, we have also seen the beginnings of a disturbing trend in the reasons why failing savings institutions fall onto FSLIC's doorstep. Three years ago, approximately 80% of FSLIC cases were primarily attributable to interest rate spread problems, and 20% were primarily due to asset quality problems. For 1984, that ratio reversed itself to 30-70 -- with the result that a substantial portion of FSLIC's caseload is characterized by bad assets. I cannot overemphasize the importance of this shift in FSLIC's problems.

Asset quality cases have proven to be up to five times as expensive for FSLIC as interest rate spread failures.

Savings and loan managers are still in the early stages of restructuring their portfolios to avoid the huge maturity mismatches which nearly drove the industry to disaster in 1981-1982. The health of the industry over the past two years has shown relative improvement over the previous two-year period, but this improvement is primarily the result of falling interest rates and certain accounting devices which exaggerated actual operating profits.

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In 1984 FSLIC-insured institutions had net income after taxes (exclusive of a special preferred stock dividend paid by the Federal Home Loan Mortgage Corporation) of approximately $1.1 billion.1/ This is substantially less than the $2.0 billion income in 1983. It represents a return on assets of approximately 0.12%, compared to 0.27% in 1983.2/ This is still, of course, sharply better than the operating picture in 1981-1982, but well below the level of profitability prevailing in the late 1970s, when the industry was considered, by relative measurements, at the peak of health.

Economic developments during 1984 also point up the industry's continuing vulnerability to changes in interest rates. The annualized return on assets declined from 0.23% in the last half of 1983 to 0.16% in the first quarter of 1984 and to a meager 0.05 percent in the third quarter of 1984.

Despite the overall profitability of the thrift industry last year, 25% of all FSLIC-insured institutions were operating in the red for the year 1984 as a whole. The ratio of regulatory net worth to total assets edged downward from 4.03% at the end of 1983 to 3.88% at the end of December, 1984. Some 29% of the industry had a ratio of regulatory net worth to total assets of less than 3%. This represents a continued decline from the 4.2% net worth ratio at the end of 1981 and from the 5.5% level in 1980.

FSLIC's reserves protect a deposit base that stood at more than $785 billion at the end of last year. By contrast, the book value of FSLIC's reserves declined from $6.4 billion as of December 31, 1983 to slightly less than $6.0 billion as of March, 1985. This was the first time in its history that FSLIC book reserves actually declined. This decrease results from the increased demand placed on the Fund stemming from a growing number of asset quality problems at some FSLIC-insured institutions. Since December 31, 1982, almost all income received by FSLIC has been expended to solve problem cases.

1/ Figures represent actual data for the first three quarters of 1984 and estimated amounts for the fourth quarter.

2/ Even including the $0.6 billion extraordinary Freddie Mac stock dividend, net income in 1984 is estimated at only $1.7 billion (0.19% return on assets), still well below the 1983 level.

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The ratio of FSLIC's reserves to insured deposits has also been rapidly approaching an historic low point. Historically, the reserve ratio (total FSLIC book reserves as a percentage of total deposits) has averaged 1.2%, peaking at 2.12% in 1970. Since then, the ratio has decreased sharply, falling from 0.92% at the end of the third quarter of 1984 to 0.76% at year end.

Of the 27 cases resolved by FSLIC during 1984, 19 were asset quality problems and only 8 were interest rate spread problems. These asset quality cases are more complex and significantly more expensive to resolve. This is especially true because, in recent months, potential acquirers of severely troubled institutions have not come forward. Some potential acquirers tend to be unwilling, for the most part, to assume the risk of large losses on bad assets.

Nevertheless, FSLIC increased its efforts during 1984 to prevent thrift institution defaults. FSLIC processed 27 cases in 1984 with assets of $5.88 billion and a net present value cost of approximately $700 million. This included resolving 18 cases with assets of $4.3 billion through the assisted acquisition process. FSLIC also placed 9 institutions with assets of $1.5 billion in receivership. The cost to pay insurance on these cases is estimated to be $450 million. (Before 1983, the total number of institutions liquidated by the FSLIC throughout its entire 50-year history was only 15).

In our current budget, FSLIC estimates that its cost for assisted mergers will increase from $801 million in 1984 to $1.9 billion in 1985 and to $2.3 billion in 1986.

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Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

May 6, 1985

Honorable James A. Baker III
Secretary of the Treasury
U.S. Department of Treasury
Main Treasury Building, Room 3330
15th and Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Secretary Baker:

We have reviewed the Treasury Department's Report to the President entitled "Tax Reform for Fairness, Simplicity, and Economic Growth" dated November 1984 ("Tax Simplification Plan"), with the Board's staff, and we find much to be admired in its concept, structure, and depth. It is a monumental work and the apparent product of extensive staff effort. As taxpayers, we are certainly sympathetic with its general thrust and the initiatives to "level the playing field." However, we have serious reservations about several unintended effects of those portions of the plan that discuss financial institutions, and savings institutions in particular. Certain aspects, especially if implemented in accordance with your proposed schedule, would simply devastate the thrift industry and the Federal Savings and Loan Insurance Corporation (FSLIC) insurance fund. We are quite sure that this was not the intended result. Nonetheless, implementation of the plan would portend dire consequences for the nation's primary source of housing capital.

Of particular concern to us are the proposed changes to Sections 368 and 597 of the Internal Revenue Code. The proposals would radically alter the tax treatment of FSLIC assisted mergers and acquisitions of troubled thrifts. Assisted mergers and acquisitions generally allow the FSLIC to resolve problem cases at costs significantly less than the cost of liquidations and with a minimum of disruption to depositors. By eliminating the beneficial tax treatment for acquirors of problem thrift institutions, the revised code would significantly reduce the pool of potential acquirors willing to work with the FSLIC on assisted transactions, and will increase the level of FSLIC assistance required in these transactions. The combined effect would be to dramatically increase the frequency of cases where liquidation is the only viable option. The drastic increase in liquidations would place the FSLIC insurance fund under critical financial stress.

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The FSLIC insurance fund and the industry it insures are entering a crucial phase in their history. One of two things are essential to their survival: much lower interest rates, or time. The former are highly unlikely, making the latter essential. However, the proposed tax law revisions eliminate the time that is needed for restructuring. They also do not address clearly the intended treatment of carry forward/carry back of net operating losses, both under normal circumstances and in reorganizations. The huge losses in the industry's recent past must be an essential element of the ongoing restructuring process, particularly if the bad debt deduction is to be eliminated as part of the "level playing field" concept, and especially if the bad debt reserve is to be recaptured as taxable income.

Our respective staffs have been discussing the points mentioned above, as well as several other problem areas in the Tax Simplification Plan. Any further information you need to evaluate the full effect of the plan on FSLIC and the thrift industry will be quickly provided. It is hoped that this process could be completed prior to any future revision of the plan and before Congressional hearings begin.

We or any member of the Board's staff would be happy to meet with you or your staff to discuss our concerns in detail.

Sincerely,

Edwin J. Gray
Chairman

Donald I. Hovde
Board Member

Mary A. Grigsby
Board Member

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ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

JUN 18 1985

Dear Mr. Hovde:

Thank you for your May 6, 1985 letter to Secretary Baker concerning the Treasury Department's proposal to repeal the special reorganization rules for financially troubled thrift institutions. I apologize for the delay in responding.

The President's recently-released tax reform proposals recognize that the thrift industry has not fully recovered from the economic conditions which prompted Congress to enact the special reorganization rules in 1981. Therefore, the President has proposed to delay repeal of these special rules until January 1, 1991 to allow the Federal Savings and Loan Insurance Corporation time to adjust the basis on which it assesses premiums for deposit insurance and to allow more time for the repayment of low rate mortgage loans held by thrifts.

We appreciate the efforts of your staff in supplying information on the thrift industry as we reconsidered the original proposal. This input was very helpful in formulating the President's proposal.

Sincerely,

Ronald A. Pearlman
Assistant Secretary
(Tax Policy)

Mr. Donald I. Hovde
Board Member
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C. 20552

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Question 17b. On potential savings and loan mergers?

1. The previously-mentioned proposals further weaken the thrift industry. They effect already critical institutions and weaken institutions which could become merger partners for our supervisory cases.

2. The proposal to terminate as of January 1, 1986, the special tax provisions which facilitate supervisory mergers of savings and loan associations would have severe adverse consequences for the FSLIC.

Supervisory mergers allow the Board to resolve problem cases at costs significantly less than the cost of liquidation and with minimum disruption to depositors. The proposal would eliminate potential acquirers willing to work with the Board on supervisory transactions, as the transactions would become taxable and the acquirors would not be able to take off the huge amount of net operating losses on the books of institutions. As a result, the increased costs would be passed on to the FSLIC. [A drastic increase in liquidations of defaulted institutions would place the insurance fund under more critical stress than it already faces.]

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Question 1 (Senator Armstrong)

Generally the FDIC is very expeditious in closing an institution. The institution is normally liquidated, merged or sold overnight. The practice of the FSLIC is to often operate the institution for a period of time before taking similar actions.

In the case of an institition in receivership or in conservatorship who is responsible for the operation and performance of the institution during that period? Is the Board of Directors and management staff personally liable for losses or decisions that might have incurred during this period?

Does not a question arise concerning the liability of the interim management the longer an institution is in receivership or conservatorship?

When conservatorship powers are invoked shouldn't Congress limit the personal liability of the bank officers and Board of Directors if the institution stays in that status for longer than 30 days?

Answer:

Conservatorship. The conservator has sole responsibility, and exercises all the rights and powers of the association. A conservator operates under regulations at 12 C.F.R. Parts 547-548, reporting to the Bank Board through the Director of the Board's Office of Examinations and Supervision (OES).

Receivership. The FSLIC as receiver has sole responsibility, and exercises all the rights and powers of the association. A receiver operates under regulations at 12 C.F.R. Parts 547-549 or 569a, reporting to the Bank Board through the Director of the FSLIC.

General. Institutions in conservatorship are operated as going concerns, and engage in a full range of business activity. Institutions in receivership are operated during the process of liquidation. For example, receiverships do not accept deposits or make loans (except loans to facilitate sale of assets), although they do engage in many business activities during liquidation.

When a conservator or receiver is appointed, it obtains all the rights, duties, powers and privileges of the board of directors and the association. Thereafter the board of directors only have the right to bring a lawsuit under 12 U.S.C. 1464 for an order requiring the Bank Board to remove the

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receiver or conservator, but the directors and management have no power or responsibility for the association's operations while under the receiver or conservator unless they are retained in some position by the receiver or conservator.

If decisions made by a board of directors or past management before the receiver's or conservator's appointment result in losses during receivership or conservatorship, they are liable for those losses.

Liability of the FSLIC as conservator or receiver is restricted by the Federal Tort Claims Act. An individual acting as a conservator may not be protected by the Federal Tort Claims Act if that individual acts outside the scope of his or her authority granted by the Board. "Interim management's" potential liablity would depend upon the facts of the case, and would not necessarily increase over time. If realized losses prove to be greater than estimated losses, the liability of those responsible for such losses would be fixed at the higher realized amount, of course.

Conservatorships are intended as temporary measures pending a final action on rehabilitation, merger, sale, or other disposition. They seldom last more than 2 years. Receivership is the last stage in a company's corporate existence: a receiver is appointed to liquidate the company, a process which usually requires 3-5 years to complete.

We see no reason for Congress to provide special protection to officers and directors of a failed bank or savings institution, when it does not provide such protection to bank or savings institution officers and directors of honestly-managed and profitable institutions.

As noted in the response above, officers and directors of companies in receivership or conservatorship have no special liability during that period. However, it is our experience that many officers and directors of such companies may be liable to the association for wrongful acts or omissions occurring before the receiver's or conservator's appointment. The FSLIC actively pursues these lawsuits in state and federal court. We strongly recommend that Congress take no action to immunize or indemnify officers and directors against the consequences of their wrongful acts or omissions. Officers and directors should continue to be liable for the consequences of their actions or failures to act.

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Question 2 (Senator Armstrong)

I am interested in learning more about the use of consultants by federal deposit insurance agencies. I have recently become aware of instances where consultants have approached third parties to provide certain services to property secured by a troubled institution, but actually having no legal authority to do so. Services have been performed but no payment has been forthcoming and the service providers find the consultant is not the responsible party.

Under what circumstances would the FHLBB/FSLIC be likely to hire outside consultants to manage failing institutions or their assets?

It is my understanding that the FSLIC as a matter of practice uses consultants in most instances to manage an institution in receivership or conservatorship. If a consultant were hired to advise or operate the institution what legal status does the consultant have to FDIC? Does it change if the institution moves from receivership to conservatorship status?

In the course of liquidating an institution, if the FSLIC were to find that it is responsible for operating a business that was financed by the failed bank and the agency hires a consultant to operate or manage the asset-What legal responsibility is the consultant under? Can he bind or represent that he can bind the FSLIC to commitments he has made?

When consultants are used why shouldn't we require a disclosure of the legal status of the consultant to the federal agency and the legal status of the property/business for which the consultant negotiates?

Answer:

The Federal Savings and Loan Insurance Corporation has contracted with private sector companies for the management of some of the problem assets in its own portfolio (acquired from failing institutions) and, as a receiver of some institutions in liquidation, for the management and disposition of some receivership assets. It is not standard practice for the FSLIC to contract out such functions, but this has been done in some large and difficult cases in which inhouse staffing and expertise were lacking. In each such contract the authority and functions of the contracting company are spelled out exactly. The Board and the FSLIC have not contracted out conservatorship functions.

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The Board has fostered contracts of failing associations with well run thrift associations under which the healthy association manages the business of the failing aassociation under the supervision of a board of directors named by the Bank Board. Neither the Bank Board nor the FSLIC are parties to such management contracts, although the FSLIC may provide back-up indemnification coverage for the managing association and its personnel.

As indicated above, when the FSLIC in its corporate capacity or as receiver contracts with an outside company for the management or dispositon of assets, the contracts in question spell out exactly the responsibilities and authority of the contracting company, including, when applicable, the company's authority to act for the FSLIC in certain circumstances. As a matter of fairness and good policy, any company or person acting as an agent for the FSLIC should disclose fully the nature and limits of the agent's authority to any person with whom the agent is dealing. It is well settled, however, that anyone dealing with a government agency is responsible for ascertaining the authority of the government's representative.

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Question 1 (Senator Gramm)

Would it be possible and desirable for the Federal Home Loan Banks to purchase subordinated debt issued by the Federal Savings and Loan Insurance Corporation?

Answer:

Section 11(k) of the Federal Home Loan Bank Act authorizes the Federal Home Loan Banks to lend to FSLIC as directed by the Board, consistent with the limitations imposed by Section 402(d) of the National Housing Act. These limitations specify that the interest on any such loans made to FSLIC by the Federal Home Loan Banks shall not be less than their marginal cost of funds and that the loans shall be adequately secured as determined by the Board. Additionally, Section 16(a) of the Federal Home Loan Bank Act outlines the types of securities as eligible in which reserves of the Federal Home Loan Banks shall be invested stating such securities as fiduciary and trust funds may be invested under the laws of the State in which the Federal Home Loan Bank is located.

When considered in the context of Section 11(K) and Section 402(d), it would be possible for the Federal Home Loan Banks to purchase subordinated debt issued by the Federal Savings and Loan Insurance Corporation as this would be construed as one specific means to lend to FSLIC. Of course, all loans made to FSLIC should be consistent with state laws regarding fiduciary investments and with prudent lending in general. Prudence would limit unsecured debt to any one entity to no greater than 10% of the lender's capital. Based on the current capital of the FHLBanks of $9.8 billion, up to $980 million in unsecured debt would be prudent.

Question 2 (Senator Gramm)

Could the assets of the FSLIC that were acquired through liquidation and mergers be turned over to the district Federal Home Loan Banks for the "workout" purposes? Could the proceeds of such "workouts" be used to retire FSLIC subordinate debt?

Answer:

The Bank Board and the FSLIC may utilize the Federal Home Loan Banks to "workout" problem assets of the FSLIC, pursuant to 12 U.S.C. Sections 1437(a) and 1701c(b). The Bank Board may also authorize the FSLIC to contract for the "workout" of problem assets. Further, the Board has chartered a federal association, under the authority of Section 406 of the National Housing Act, 12 U.S.C. Section 1729, to facilitate the liquidation and take over the assets of failed insured institutions ("Federal Asset Disposition Association" or FADA").

It is the Board's intention that FADA be utilized to dispose of FSLIC assets. It is expected that the resources available to the FADA would make possible a more effective and profitable liquidation of assets, particularly problem assets, and maximize the return to the FSLIC; that is to say, wring out every last penny from the disposition of such assets in behalf of the FSLIC.

Proceeds from the disposition of such assets could be used by the FSLIC to increase its cash reserve or to retire its obligations.

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Question 1 (Senator Cranston)

The growth in securitization of mortgage loans through such vehicles as the mortgage backed security and the collateralized mortgage obligations, has been phenomenal over the last five years.

I have been working with one industry group to develop a proposal to permit a multi-class pass through under the grantor trust rules of the Internal Revenue Code and to clarify the taxation problems of the CMO. In general the proposal would remove taxation from the pool level of the CMO and allocate it to the investors and set on allocation scheme for the prepayments, phantom income and OID. Basically both measures will offer "call protection" for investors and permit thrifts to sell off their low yielding mortgages without having to book losses over collaterizing the CMO.

Could you give me you views of the benefit of clarifying the existing taxation problems surrounding a multi-class pass thru and the CMO to the thrift industry?

Answer:

Much of the growth in the secondary mortgage market can be attributed to new and innovative investment vehicles created to make the secondary market more attractive to capital market investors. The Collateralized Mortgage Obligation (CMO) is one of the more successful instruments to bridge these two markets and attract new investors.

The CMO is a bond-like structure that offer both short, intermediate, and long term investments. Principal on the CMO is paid as principal on the underlying pool of mortgages is paid. The intermediate and long term investor receives a form of "call protection" by being assigned the principal cash flow from the mortgages in the pool that are outstanding the longest (e.g., those lasting closest to the fully 30-year term of the mortgages). Investors seeking short term investments are assigned cash flows from mortgages in the pool that prepay earlier. Both the CMO and the multiple-class mortgage-backed security under consideration by Senator Cranston offer this fast/pay, slow/pay investment feature.

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Under the current tax rules, a multiple-class mortgage-backed security can effectively only be offered as debt of the issuer. Likewise, CMO investors are considered to hold debt of the issuer, and not a mortgage asset. As a result, a CMO does not qualify as a mortgage asset for purposes of thrifts' bad debt tax deduction and other regulatory purposes. A debt classification raises problems for thrifts that are limited in the amount of debt they can carry on their balance sheets.

The Cranston proposal would allow for an ownership interest in a passive multiple-class security by modifying current grantor trust tax rules. The result would be that the issuance will be treated as a sale of assets and the investment as an investment in mortgages.

Both the proposed security -- as an "asset sale" security -- and the CMO -- as a "debt sale" security -- are viable thrift restructuring tools and investment vehicles and, together, provide thrifts with more flexibility in managing their mortgage portfolios.

Existing tax rules impose another problem for multiple-class security issuances like the CMO. Under current tax law, it is unclear how mortgage prepayments are to be accounted for and taxed. Interpretation of these rules for issuances may sometimes produce so-called "phantom-income" or the possible conversion of ordinary income into capital gains. Several remedies to these problems are currently under consideration by the housing finance industry and clarification would be a benefit to the entire secondary market. Some of these proposed remedies are very complex and technical in nature. We would expect that any effort to clarify these current tax rules would take into consideration the need to match "real" economic gain from the security with the taxation of that gain.

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QUESTION

In the bill, S. 1167 introduced by request of the Federal Home Loan Bank Board, it appears from the language that you have eliminated the language in Sec 408 of the National Housing Act that set up the sequence for supervisory mergers of minority controlled thrifts. As the original author of this section, I am most concerned that it has been removed from this proposed draft for extension of authority under the Garn-St Germain Act.

Would you indicate if it was your intent to eliminate this section? If so, explain why.

ANSWER

As part of the Federal Home Loan Bank Board's overall legislative strategy for strengthening and protecting the FSLIC, as set out in S. 759 and S. 1167, the Board is proposing to eliminate all bidding priorities established by section 123(a) of the Garn-St Germain Act, including the preference for minority-controlled institutions. By increasing the flexibility of the FSLIC to negotiate emergency thrift acquisitions without established bidding preferences and procedures, the Board believes that offers received in such situations will present more creative suggestions beneficial to the interest of the FSLIC and encourage qualified and much needed investment capital sources, both in-state and out-of-state, to actively participate in the restructuring of financially distressed insured institutions.

Under the current bidding process established by section 123(a), if the qualified offer presenting the lowest expense to the FSLIC is from an institution that is not an in-state insured institution or an in-state savings and loan holding company, then additional offers will be permitted from any offerer whose original bid was within 15 percent or $15,000,000, whichever is less, of the initial lowest acceptable offer. The Board believes that this bias against out-of-state bidders discourages them from participating in bidding conferences, thereby precluding potential offers presenting the lowest expense to the FSLIC from outside of the state in which the financially distressed thrift is located.

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Question from Senator Sasser

When you arrived at the Bank Board in June of 1983, the prime rate was at 10.5 percent. That was just about half of the record rate endured by your predecessor, who will testify later this morning.

I say "endured" because of the tremendous pressure that high market interest rates put on the thrift industry.

Now, I am not anticipating a return to those days in July of 1981 when the prime was at 20.5 percent. And, at least for the near-term future, I think we can expect rates to stay relatively low to avoid further stagnation of the economy.

But it doesn't take much of an up-tick in rates to have a profound effect on the thrift industry. And when there's a threat to the industry, there's a threat to the Federal Savings and Loan Insurance Corporation, the F.S.L.I.C.

I want to get an idea here of what has happened in the past few years to reduce the threat posed by high interest rates to the industry.

Adjustable rate mortgages ... expansion of the secondary market ... restructuring ... all of these are playing a part in insuring that we do not have a recurrence of the crisis that devastated the industry in the last recession.

How important, in your view, is each of these factors?

How much protection will each of them afford in the event of a major increase in interest rates?

Answer:

As stated in our answer to Senator Proxmire in response to his question on interest-rate mismatch, through the use of adjustable-rate mortgages (ARMs), mortgage-backed securities, and interest-rate swaps, the savings and loan industry has steadily worked towards reducing its interest-rate risk exposure. The Bank Board has encouraged and facilitated these adjustments. As a result, our new reporting system indicates that the interest-rate risk exposure of the industry has declined. Between March 1984 and March 1985 the cumulative interest-rate gap under three years in maturity as a percent of assets declined significantly from 45% to 33%.

The Bank Board has strongly advocated the use of ARMs as a fundamental tool for reducing interest-rate risk. The rising proportion of ARMs among all loans closed--from 26 percent in May 1983 to 75 percent in August 1984--indicates wide acceptance by the market. Although current low interest rates make ARMs slightly less desirable to borrowers, the adjustable-rate mortgages remains the primary method to hedge interest-rate risk. Preliminary June 1985 figures indicate that ARMs now account for over 40 percent of the single-family mortgages held by thrifts. This is a substantial increase from the March 1984 figure of 26 percent.

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Utilization of the secondary mortgage market has also proven effective in reducing maturity mismatches. By June of 1985 thrifts held approximately 10 percent of their assets--over $102 billion--in mortgage-backed securities. Because these instruments are more liquid than whole mortgage loans, portfolios including them can be adjusted at a lower cost in the event of rising interest rates.

In July of 1984, the Bank Board authorized S&Ls to establish finance subsidiaries for the purpose of issuing collateralized mortgage obligations (CMOs). The CMO represents an innovative improvement over traditional mortgage-backed securities. By refining the method for distributing mortgage prepayments, the CMO has proved attractive to the market. As such, CMOs provide thrifts with a relatively low cost source of funds. In addition, like other mortgage-backed securities, CMOs allow a thrift to restructure its portfolio to be less interest-rate sensitive.

Finally, the increasing ability of thrifts to swap fixed-rate interest payments for variable-rate payments has significantly contributed to a reduction in interest-rate risk. Savings institutions can now undertake an "interest-rate swap" which serves to reconcile the differences in asset and liability payment structures. The Bank Board, in 1984, presented interest-rate swap guidelines that have helped open this avenue to all institutions. District banks can now support financially weak institutions in swap arrangements and act as swap counterparties to smaller institutions, boosting their collateral to necessary levels. By the end of 1984, eight district banks already held $2.3 billion outstanding in swaps with their members.

Although none of the above measures alone could fully insulate the industry--and the FSLIC--from interest-rate risk, in concert they provide effective and flexible means to reduce mismatches in portfolio payment structures and maturities.

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Questions for Chairman Gray from Senator Sasser

Question:

The book value of the F.S.L.I.C.'s reserves declined, for the first time in history, between the end of 1983 and the end of 1984. Book reserves as of December 31 of 1983 were at $6.4 billion. By December of last year, they were valued at slightly less than $6 billion, about $5.6 billion.

In February and again in May, the Board assessed special premiums of 1/32 of one percent. Book reserves are now at about $6 billion.

Do you anticipate any further need to increase premium payments by all thrift institutions? Would you ask for authority to exceed the statutory limit of one-eighth of one percent per year?

Answer:

Under current federal statutes, each FSLIC-insured association is required to pay an annual cash premium to the corporation equal to 1/12 of one percent of the institution's total deposits. The regular premium is first paid at the time of membership, and then annually thereafter. In addition, to recoup losses and expenses, the FSLIC may assess additional premiums, which are not to exceed 1/8 of one percent of member deposits in any year.

In 1985, for the first time in its history, the Board utilized its special assessment authority. Insured institutions were required to pay four special premiums, each amounting to 1/32 of one percent of deposits during the year. These special assessments produced an estimated annual income of over $1 billion for the calendar year. Use of the special premium assessment has had an ameliorating effect on the size of the reserve fund, and is an option the Board intends to review on a quarterly basis throughout the upcoming years while alternative solutions are pursued.

One alternative the Board is pursuing is a plan which would address the increased risk of certain activities of some associations by application of higher annual premiums to these institutions. An expansion of powers at both the federal and state level has allowed FSLIC-insured institutions to engage in activities which present a wide range of risks to the insurance fund. The risk-based premium plan would provide a schedule of supplemental premium charges for asset-based activities which

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exceed the limitations established by the federal legislation found in the Homeowners Loan Act and the 1982 Garn St Germain Act. The supplemental charges would vary according to the relative risk of each activity, and the net worth capacity of each institution to assume the increased risk. It would not impose a change in premiums for activities which fall completely within the federal quidelines, unless an accumulation of data would identify increased risk and justify adjusting premiums for a federally approved activity.

Legislation which would authorize the FSLIC to assess flexible insurance premiums based upon relative risk posed to the fund has been before the Congress in 1984 and 1985. The Board has not asked for an increase in the statutory limit of one-eighth of one percent per year. If, on balance, circumstances appeared to warrant asking for such an increase, could, of course, foward such a request. However, any such request would include with it a full justification and a comprehensive plan for exercise of any additional authority requested.

In summary, exercise of the Board's current authority for special assessments helps to stabilize the reserve fund.

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The CHAIRMAN. Next, I'd like to invite to the witness table Mr. Richard T. Pratt, former chairman, Federal Home Loan Bank Board; and Jay Janis, another former chairman of the Federal Home Loan Bank Board.

It looks like we're having Old Chairmen's Day at the Senate Banking Committee today. Mr. Pratt, would you like to be the first old Chairman to testify?

STATEMENT OF RICHARD T. PRATT, FORMER CHAIRMAN, FEDERAL HOME LOAN BANK BOARD

Mr. PRATT. Thank you, Senator Garn. It's nice to be here. I had forgotten how much fun these were.

The CHAIRMAN. You don't have 2½-hour meetings you have to listen to at Merrill Lynch?

Mr. PRATT. Well, they're of equal interest, let me assure you.

I have, of course, followed this with great interest, both when I was Chairman of the Federal Home Loan Bank Board and since then, and I think the time is certainly opportune for the consideration of this. In fact, I think the insurance corporations are essentially in a crisis.

I'd like to make a very brief statement and hopefully lay out a program which I think is helpful and provides some food for thought in this regard.

HISTORY OF INSURANCE CORPORATIONS

First, the insurance corporations have served us well, but they have served us in a period of time that has changed rapidly from the period of the 1930's to the present time, and to expect that they could structurally remain relatively unchanged and continue to operate effectively I think strains the believability, and in fact we are seeing a disintegration of the system at this time.

When these insurance corporations were first established, we had local, isolated markets. We were able to grant banks and thrift institutions local monopolies which were quite valuable, and simply through moral suasion and a relatively simple set of regulations and supervisions to get them to behave in a fashion which mitigated against risk and which allowed for a relatively stable system.

As technology changed, especially the technology of computers, communication, and the media, the outside competitors were able to come in and offer competitive instruments to regulated financial institutions and it was clear that deposit regulation was causing a major problem. Depositors were denied a fair rate of return on their savings. Thrift institutions and banks were unable to attract funds and make managerial decisions as to what funds were needed in their area.

This, of course, came to a head with the Depository Institutions Deregulation Commission eliminating the control on interest rates and the Garn-St Germain Act giving greater flexibility, especially to the thrift industry in its asset and liability situation.

The problem that then came to the forefront and which perhaps many of us should have seen more clearly was the fact that we had done what needed to be done, we had done what the public interest

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demanded, we had provided equity to consumers and given them fair rates of return, we had provided reasonable flexibility, but we had done so while relying on insurance corporations that were vintage 1930 and they were simply inadequate to the circumstances.

Presently, financial institutions can offer Government guaranteed deposits to the public in unlimited amounts. Institutions, while acting essentially as private entrepreneurs in the disposition of funds, are borrowing as if they were agents of the U.S. Treasury. The intelligent consumer is led to place his deposits in the institutions offering the highest returns and, quite properly, disregards both the quality of assets and the quality of management associated with the institution.

As a result, the probability of inefficiency, misallocation of resources, and financial losses to the insurance corporations is inordinately high.

Given that problem, the question is, of course, what is the solution? I would like to say that there are really two problems that have to be dealt with. One we can call the old problems, and this is the fact, especially in the thrift industry, that there is little or no real capital in many of the institutions. The institutions on an economic basis have negative capital and it is not clear how one deals with that problem. It is a problem to some extent of being caretaker management. Some of these institutions, because of their operating advantages, may be able to overcome the fact that no real capital exists. But in general, institutions with negative capital will not survive and that problem cannot be addressed by creating a more efficient insurance corporation.

That leads to a set of questions which are very vital and which Congress must consider: Does the FSLIC presently have sufficient financial resources to deal with the problems which will occur? If it does in its present form, then everything is all right and we can go back to other considerations. If it does not, then we obviously move to a higher level of consideration and ask the question: Does the industry as a whole have the self-help ability to solve the problems which occur in this industry, and even if it does, what will be the effect on the industry from solving its own problems?

If it does not have the ability to solve its own problems and if self-help is insisted on through higher and higher insurance requirements, then what we will see is strong institutions join arm in arm with the weak and march into oblivion. Even if the resources are there, strong institutions may be so weakened by attempting financially to solve the problems of all of their weakened brothers that this may be rather devastating.

There are possible solutions to this. Two of which have been suggested are the merger with the FDIC which may have better access to cash or capital, and second and perhaps unthinkable to this group, but the possibility that in fact the Treasury of the United States may have to write some checks at some time.

I think it's important that Congress think about the macroability of the insurance corporations and the FSLIC to solve its problems, have a clear handle on that ability, a good audit, a good financial plan of the next several years.

Laying that macroproblem aside, let me talk about possibilities for making the insurance corporations work more effectively.

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TWO POSSIBLE POLES FOR FEDERAL INSURANCE

First, I'd like to say that I think there are really two possible poles that you can look at in the provision of Federal insurance. One is to insure only riskless activities. This would be institutions which invest in U.S. Government securities on an overnight basis. Those institutions would have neither interest rate risks nor credit risks. Obviously, insurance would be very simple and you would be providing only a simple payments mechanism.

At the other end of the spectrum, we can have insurance of the type which is now offered with certain economic activities allowed. However, unless some market discipline is brought, there will be more and more pressure for the Government to take over the operation of our financial institutions and unless market discipline and pressure is brought to bear on the insurance functions, what we will have is Federal Government operated banks and savings and loan associations where the supervision and regulation is so complete as to lay out the decisions for management and limit the risk-taking to activities with which the Government is comfortable.

This may sound far-fetched, but this is really sort of a national branch banking system with the regulators sitting as the mother bank. I think that that's essentially, to some extent, the course that we're on unless Congress and regulators do come up with some fundamental restructuring.

In the middle ground, that is the ground between insuring only riskless activities in which case insurance is meaningless, or insuring many activities but totally describing those activities and managing the institutions, there's a middle ground of trying to bring behavior to financial institutions and the public such that they will behave in a fashion similar to the way they would behave if insurance did not exist. That is, if they were to allocate the funds that are available in this country in the sense of economic efficiency and appropriateness with proper regard for risk.

I have made six suggestions in my testimony, none of which are especially original but which when taken in combination I think provide for the efficient provision of insurance.

First, management information. We don't know which institutions in this country are solvent and which are insolvent, and generally accepted accounting principles [GAAP] accounting is essentially as bad as regulatory accounting principles [RAP] accounting. The statement has been made before and I have made it that good financial disclosure bears the same relationship to GAAP or RAP accounting for a thrift institution as military music bears to music. And that is apparently a tenuous connnection.

I think perhaps the single biggest quickest reform we could make would be to improve the management information system which is available to the regulators, and this is essentially going to some mark to market accounting. People will whine and cry that it's difficult or nearly impossible to do, but the more we know about what our institutions are really doing and what they have, the better able we will be to regulate them. And the amount of manpower that's required in the Federal agencies to control institutions with good management information is going to be far less than under the present circumstances. And I can say this having been a party

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to many of the mirrors and blue smoke that exist. So it is with my own scars that I come to these conclusions.

We will have to recognize that institutions which may in fact be insolvent, there may be reasons to let them operate, but I would suggest that knowing their true financial condition will lead to the best possible solutions and that improving managerial information is a very high priority.

The second requirement is adequate capital. There's just no question that risk capital needs to be there to support risk-taking activities and I understand that certainly for much of the thrift industry and the commercial banking industry you can't create capital for the old structures. It just is not going to be available. And that is a different problem. That is a problem of the adequacy of the FSLIC and the FDIC to deal with. But in terms of new activities going forward, it must be supported by real capital.

I think, to some extent, the perhaps greater success of the FDIC as compared with the FSLIC has been simply a result of the fact that greater capital is required. If we look at what FDIC-insured institutions are able to do, they are able to undertake the most risky and the most risky investments which possibly exist and in general have done that with substantial success. The single most risky loan I can think of is lending to a college professor, which I used to be and which they used to do, or lending to the Dairy Queen on the corner, or the service station. This is much more risky than a junk bond or other major activities, and yet commercial banks have done it with great success. I think a major reason is that historically there has been real capital and when you extract the macroagricultural problems, oil problems, and foreign loans, I think commercial banks continue to take very great risks with great success and I think it's based on capital adequacy.

A third suggestion that I think needs to be evaluated is risk-sharing between depositors and the insurance corporations. At the present time, depositors have no incentive whatsoever to seek out well-run institutions. In fact, they may seek out the more poorly run institutions in the hopes that they will receive a higher rate of return. The risk is precisely the same independent of the competence of management and we are losing the discipline which depositors can bring to the insurance corporations.

Variable insurance premiums or variable capital? This is obviously something which has been discussed here to a great extent. I think they have a role to play. I guess I'm coming more and more to the conclusion that maybe variable capital requirements make more sense than variable risk premiums, but variable capital requirements are really the same as variable risk premiums, and that activities can be generally determined according to their riskiness and those which are more risky should require more capital to support that risk undertaking or a higher risk premium.

Those who argue that this is impossible or difficult, of course, it's difficult, but the present situation is difficult and I think the consequences of leaving the system unreformed far exceed in ultimate difficulty the questions which must be asked in order to make these changes.

The fifth suggestion I would make is, with the others implemented, we should have total and full disclosure of financial informa-

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tion. Disclosure at this time doesn't make any difference. As I said, if you give a consumer greater disclosure about the credit quality of the institution, he may well seek out the lowest credit quality because it will probably pay the highest interest rate. If he bears some of the risk, if other reforms are incorporated, then disclosure is absolutely essential in the interest of fairness.

Finally, requiring a high standard of fiduciary conduct for officers and directors of financial institutions. I think we're moving in this direction and needs to be done with great vigor. I think those who play outside of the rules of the game should be called to account for it.

Some of the above suggestions may not be workable or may be difficult to implement. Many of them will likely result in the elimination of the weakest of our insured financial institutions. These are negative factors.

At the same time, the present system is unworkable. The problems which exist at this time will tend to increase in both magnitude and intensity and if the fundamental reform of the regulation, supervision and insurance of financial institutions is not undertaken the path of least resistance will lead to the management of insured financial institutions by the Federal Government. The system left to its own devices will tend to provide monopolistic subsidies to the financial industry at the expense of the public and will promulgate such restrictive regulation that economic growth and development will be stifled. Time is of the essence and reform should take place now.

[The complete prepared statement follows:]

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Statement of

Richard T. Pratt
Chairman, Merrill Lynch Mortgage Capital, Inc.

Chairman Garn, Members of the Committee, I appreciate the opportunity to appear before you and express my views concerning the reform of the federal deposit insurance system. Since their inception in the 1930s, both the FSLIC and the FDIC have had a remarkable record of success. Today, however, they face severe problems. They are structurally obsolete as a result of the technology of today's financial intermediation and the nature of the financial markets. If financial institutions are to promote stability and foster economic growth, federal deposit insurance needs to be restructured.

The Background of Federal Insurance

Federal deposit insurance was created when the financial markets and technology were, by today's standards, relatively primitive. To a large extent national insurance was a product of the historical evolution of unit banking in the United States. The unit banking structure provided immense burdens both for government and consumers in understanding and evaluating the myriad of independent banking units. The consumer's cost of obtaining financial information to make intelligent deposit choices was burdensome. The relatively small size of individual banks and their dependence on individual economic conditions increased the risk of a single bank experiencing difficulty. A unit bank is vulnerable to economic downturns in the local economy, unusual local needs for liquidity, and developments

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within the bank or its management which might affect the confidence of depositors. In other countries, many of these difficulties were mitigated by a branch banking system where banking was carried out by one or a few banks of substantial size having national branch networks. National branch banking provides many safeguards to depositors which are difficult to provide in a unit banking system. Branch banking allows an easy and effective interface between the Central Bank and the nation's banking structure. The Central Bank and governmental policy makers can more easily monitor the direction and condition of one or a few banks and can provide regulation and supervision essentially by direct negotiation with Bank management.

In this country, the Federal Reserve and the government banking insurance systems have become a substitute for the controls and stability inherent in a branch banking network. Bank managements had no incentive to take excessive risks or engage in unsound practices because the system effectively shielded them from competition. Individual banks had a geographic monopoly, insured deposits, interest rate ceilings, access to the Central Bank for liquidity purposes and a monopoly on offering payments services such as checking accounts. Financial markets were generally local in nature and competitors did not have effective tools to provide alternative banking services to the federally insured and regulated institutions.

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Two major factors eroded the effectiveness of the deposit insurance corporations. First, technology was changing, allowing for new approaches to the provision of financial services. Major technological changes included the development of the computer and high speed, efficient, low-cost communications services; and the creation of mass markets accessed through the television media. Even with these technological changes, the system continued to function with a relatively high degree of effectiveness, until the late 1970s, when pressures on insured financial institutions were becoming more evident. The regulation of deposit interest rates prevented institutions from increasing their deposit bases by raising interest rates. As a general rule, institutions grew at the rate of economic growth experienced in the local economy. When inflation reached high levels, the regulation of interest rates caused funds to flow out of insured institutions as depositors sought higher yields in substitutes such as money market funds. The rapid growth of these funds in the late 1970s and early 1980s demonstrated the vulnerability of insured deposits to outside competition.

Deposit rate regulation constrained the exercise of managerial discretion on the part of insured financial institutions and denied the consumer the right to earn competitively established market rates of interest. By the early 1980s, deposit rate regulation was doomed and was finally eliminated by the action of

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the Depository Insitutions Deregulation Commission.

The Present Problem

The existence of federal deposit insurance, the technology for raising insured deposits on a massive basis, and the elimination of interest rate controls combined to make the traditional system of financial institution regulation and insurance untenable.

Presently financial institutions can offer government guaranteed deposits to the public in unlimited amounts. Institutions, while acting essentially as private entrepreneurs in the disposition of funds, are borrowing as if they were agents of the United States Treasury. The intelligent consumer is led to place his deposits in the institution offering the highest returns and quite properly disregards both the quality of assets and the quality of management associated with the institution. As a result, the probability of inefficiency, misallocation of resources, and financial losses to the insuring corporations is inordinately high. While the potential for problems has always existed within the system, the technology which allows efficient funds gathering on a large scale basis and the ability to freely price deposits has created an actual operating crisis for the FSLIC and FDIC.

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Unfortunately the regulators have appeared to confuse the problems of the insurance corporations with the deposit gathering system. This is well illustrated by the current controversy concerning brokered retail certificates of deposit. Because of the credit enhancement provided by federal insurance, banks and thrifts are able to access deposit funds of various maturities through outside marketing networks such as Merrill Lynch. This approach to funds acquisition provides benefits to both the financial institution and to the consumer. It provides a powerful tool to the bank or thrift for accessing funds of various amounts and maturities which would not be available in its local markets. It allows better asset liability management through maturity matching and the ability to acquire funds without inappropriate investments in cumbersome branch networks. This mechanism allows consumers access to competitive market rates regardless of the availability or efficiency of their local markets. Regulators have never attempted to refute the benefits of the brokered C.D. market. Their criticism stems from the fact that it is efficient and does work. A well conceived deposit insurance system should incorporate the benefits of deposit brokerage system. It is a telling indictment that regulators find the fairest, lowest cost system of funds acquisition to be a problem for the insurance corporations.

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A Framework For Reform

There are several possible approaches to the present problems to the insurance corporations: (1) elimination of federal deposit insurance; (2) providing federal deposit insurance only for no-risk funds, that is, requiring that institutions which offer federal insurance limit their investments to government obligations having neither credit nor interest rate risk; (3) the de facto nationalization of financial institutions by providing such comprehensive regulation and supervision that the institutions are effectively managed by the federal government; or (4) attempting to devise reforms for insurance, regulation, and supervision which allow meaningful managerial flexibility on the part of insured financial institutions while still imposing a market discipline on their operations.

Although eliminating federal deposit insurance or limiting deposit insurance to institutions holding only risk free assets may seem most appealing in a public policy sense, the operating and political difficulties in achieving such a system are formidable. Alternatively, the cost in efficiency and equity of allowing federal regulators to become the de facto managers of the nation's financial intermediaries seems to be inordinately high. The regulatory path of least resistance is one which substitutes government decision making for decision making of risk-bearing entrepreneurs and managers.

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If elimination of insurance and de facto nationalization of managerial decisions are rejected, the remaining course of action is one which reforms the FDIC and FSLIC to cause financial institutions to allocate resources and make decisions as if federal deposit insurance did not exist. It is not clear that this end can be achieved. Modifications to the insurance corporations will cause a certain amount of destabilization. Changes will be controversial. There is a substantial question as to whether or not regulators have sufficient incentive to make the difficult decisions necessary to achieve the required reform.

I have, in other forums, suggested six approaches which I believe taken in some combination could help increase market discipline for insured financial institutions and mitigate the unacceptable exposures presently existing for the insurance corporations. These six steps are as follows:

I. Improved Management Information

Generally accepted accounting principles and regulatory accounting principles provide little insight into the true financial condition of financial intermediaries. This is especially true for thrift institutions but is also a significant problem for commercial banks. Accounting and financial techniques are grossly inadequate in measuring both the effects of interest rate and credit risk. The most glaring example is the

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inability of both GAAP and RAP accounting to measure the gains and losses from interest rate risk. An institution having a mortgage portfolio of $1,000,000 of unpaid balance will reflect an asset of $1,000,000. In an 11% interest rate world if the mortgage portfolio is in 6% mortgages the real asset value is only $718,875, a misstatement of over 28% of the balance sheet value. In a similar, but less easily identified fashion, losses resulting from credit risks may be disguised from regulators and the public for an extended period of time. Accounting treatment for financial institutions should be based on the closest approximation possible to reflecting the current value of assets and liabilities. While adjustments for current value considerations are somewhat complicated, any reasonable approach to the reflection of current value will provide a substantial improvement over the status quo.

Making adjustments for interest rate risk are relatively straightforward. Adjusting for credit risks is more time consuming, requires more expertise and is more costly. The approach that should be followed in this regard is to focus on those assets which represent a significant risk concentration for the institution. For example, a construction loan which represents 20% of the capital of a financial institution should be evaluated and an estimate of current value arrived at. Similarly, a group of single family residential loans con-

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centrated in a single condominium development should be similarly evaluated. By focusing on meaningful risk concentrations and transactions which are made under non-standard market conditions, a reasonable approximation of the current value of assets can be arrived at.

Perhaps the greatest single improvement in the ability to examine and supervise financial institutions is a reformation of the accounting and management information systems which are the basis for public scrutiny of operations. Moving to current value accounting will result in a large number of financial institutions showing zero or negative economic net worth and so this reform will be resisted. This issue was examined by the Federal Home Loan Bank Board during the difficult economic period of 1981 and 1982 and the board chose not to go forward with substantial reform of accounting and management systems. In hindsight this appears to have been a bad decision. An early move to implement current value accounting may have prevented many of the economic losses subsequently suffered by the FSLIC. Further delay of this reformation will impose further substantial costs on the system.

II. Requirement of Adequate Capital

Many segments of both the thrift industry and the commercial banking industry are operating with zero or negative real capital. These institutions have incentives to take inordinately

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high risks in the hope of generating sufficient income to reestablish a capital base. Such risk taking is inconsistent with the provision of federal insurance and the market system under which our economy is organized. Providing additional real capital to support existing asset liability structures is difficult and, in many cases, may be impossible. To the extent it can be acheived, it will be facilitated by generally opening up the acquisition of financial institutions to well-capitalized, responsible acquirers. Additional asset growth should not be allowed or should be severely limited for institutions not able to provide additional risk capital commensurate with asset growth.

III. Risk Sharing Between Depositors and Federal Insurers

Depositors can also be expected to act as rational economic entities in choosing where to place their funds. The immense power of the depositing public to effect banking behavior is left untapped by the present scheme of federal insurance and regulation because currently no depositors bear any risk of loss from inept, inappropriate management of financial institutions. A system in which the depositor, particularly the larger depositor, bears some risk based on the performance of the financial institution would provide market discipline and would channel deposit flows to better managed, more soundly capitalized financial institutions. Risk could be transferred to the

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consumer by uninsuring some first percentage of deposits. For example, with a 3% co-insurance scheme, the depositor would be uninsured for the first 3% of his deposit balance. Thus, in the case of a, say, a $100,000 deposit by an entity at an insured financial institution which failed it would be a general creditor for the first $3,000 of that deposit and would receive federal insurance coverage on the remaining $97,000. The first $3,000 could be left uninsured or could be covered by private insurance. Such a co-insurance scheme, especially if phased in over time, would encourage evaluation of the quality and risk of a financial institution while not exposing such depositors to ruinous financial losses.

IV. Variable Insurance Premium or Variable Capital Requirements

The Insurance Corporations could require higher insurance premiums for riskier activities or, alternatively, higher capital requirements to back riskier asset categories. The problems associated with variable premium or variable capital requirements have been extensively discussed elsewhere. However, any approach to insurance premiums or capital structure which better reflects risks would be an improvement over the present flat premium structure.

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V. Disclosure of Financial Information

At the present time, disclosure of financial information concerning insured institutions provides little or no benefit to the consumer. There is no reason for a consumer to seek information about an insured depository or to act on that information if it is provided. However, if co-insurance is implemented as previously discussed, then the consumer must be provided with full financial disclosure.

VI. Requiring a High Standard of Fiduciary Conduct of Officers and Directors of Financial Institutions

Officers and Directors should fully understand the rules of the game and should be held accountable for their stewardship of the public's financial resources.

Conclusion

Some of the above suggestions may not be workable or may be difficult to implement. Many of them will likely result in the elimination of the weakest of our insured financial institutions. These are negative factors. At the same time, the present system is unworkable. The problems which exist at this time will tend to increase in both magnitude and intensity and if a fundamental reform of the regulation, supervision and insurance of financial institutions is not undertaken the path of least resistance will lead to the management of insured financial institutions by the Federal Government. The system left to its own devices will tend to provide monopolistic subsidies to the financial industry at the expense of the public and will promulgate such restrictive regulation that economic growth and development will be stifled. Time is of the essence and reform should take place now.

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The CHAIRMAN. Thank you, Mr. Pratt.
Mr. Janis.

STATEMENT OF JAY JANIS, FORMER CHAIRMAN, FEDERAL HOME LOAN BANK BOARD

Mr. JANIS. Mr. Chairman and distinguished members of the committee, I'm very grateful to the committee for inviting me to testify today. You know, when you give a former Bank Board Chairman the opportunity to come back to Washington to say whatever he wants about his successors, or the Congress, or the administration, or whomever, it makes me feel like a 5-year-old let loose in a candy store. It's so tempting, I hardly know where to begin.

But at the outset, I certainly want to express my regard for those who have succeeded me as Chairmen. In my mind, Dick Pratt and Ed Gray have both been the right men at the right time.

A week ago Sunday in a fine article in the New York Times, Dr. Henry Kaufman posed a question that's been gnawing away at those policymakers who concern themselves with financial institutions in America. The question was this: Is deregulation compatible with federally backed deposit insurance? Or more specifically, can you allow financial institutions to have unfettered or even unlimited powers to make risky investments and at the same time allow them to enjoy the benefits of Federal deposit insurance?

This question lies at the heart of what these hearings are about I suspect, and my answer to the question—is deregulation compatible with deposit insurance—is a clear and decisive maybe.

DEREGULATION CAN BE COMPATIBLE WITH FEDERAL INSURANCE

It really depends on how you define deregulation. If deregulation of financial institutions means the right of an insured institution to pay market rates for deposits and greater latitude to make investments but not unlimited freedom to do so, then the answer is yes.

It is also yes if financial institutions understand that deregulation means more examination and supervision instead of less, if Congress understands that it must remove the constraints on the regulatory agency to get its job done properly, and if the regulator understands that it must target very precisely on real problems rather than on imagined ones.

Under these conditions, I believe that deregulation is indeed compatible with deposit insurance and very little structural change in the system is necessary.

Before giving specific answers to some of the questions posed by the committee, let me provide some brief background to put my remarks into perspective.

I believe that the problems that have emerged over the last several years, the problems that form the basis for the inquiry by the committee, are really the natural workings out of the process of deregulation of financial institutions, particularly thrifts, that took place in the 1979–83 period. Other industries, such as trucking, communications, and airlines, went through a similar process at the same time with certain related problems.

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The deregulation of savings and loans, however, has one major difference. Deregulation, by its very nature, is after all a form of economic or financial Darwinism. The survival of the fittest means that some don't survive, and that brings its own kind of trauma to the entire system in terms of public confidence.

Therefore, the difference with respect to financial institutions is that market forces cannot be allowed to determine who survives and who fails. That's the job of the regulator.

Unfortunately, there are flaws in the way the savings and loan business was deregulated. For one thing, the process was backwards. Assets should have been deregulated at least 5 years ahead of deposits so that balance sheets could have been restructured. I'm talking here about restructuring in terms of the mismatch in maturities resulting from years of borrowing short and lending long, a practice virtually required by law and regulation for close to 45 years.

Other flaws include the lack of planning to anticipate the problems that deregulation would bring, such as the cause and effect relationships created when State legislatures rushed to outdo the liberalized powers granted to federals or the issue of how to cope with the public confidence factor in the face of failing institutions.

The deregulation of S&L's also had the misfortune to occur just at the time of the worst interest rate spike in modern history and this was compounded by the coincidence of real estate price disinflation. When 80 percent or more of S&L portfolios are made up of real estate loans, the effect on delinquencies should be obvious.

Nevertheless, deregulation represents a watershed for thrifts, a fundamental break with the past from which there can be no turning back. Once the cork was pulled the genie of deregulation with all of its flaws and unfortunate timing was out of the bottle forever.

That problems have occurred should have surprised none of us. For instance, when deposit deregulation occurred, the ability to pay higher market rates for deposits meant greater cash flows into the institutions. That means too much money chasing too few deals, and that adds up to greater risk.

When Congress granted greater powers to Federal associations, this meant some States would try to outdo Congress with even more liberal powers, virtually unlimited in California. This meant the State charter became a very valuable commodity. The result was a new breed of fast buck, high flyer, entrepreneurs who were enticed into the business.

When failing institutions resorted to throwing the "Hail Mary" pass to stave off insolvency and the regulator, this meant even bigger losses, adverse publicity, and the erosion of public confidence.

Now the Bank Board's response to date has had the desired effect of slowing down the process of deregulation with a number of broad brush regulations. Most of these actions I believe were necessary, although the weapon used was a shotgun. What I see emerging now finally is the understanding that what is needed is a rifle shot rather than a shotgun blast. In other words, focusing on what the true problems really are—namely, interest rate sensitivity risks caused by the mismatch in portfolios, and credit risks caused

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by the high flyers, the ultra high rapid growers, and most particularly by poor underwriting and point-driven investments in real estate transaction. Clearly, it's a waste of time to focus on much else.

RESTRUCTURING AND BETTER REGULATORS

What's needed then are incentives and disincentives for institutions to restructure, coupled with the regulators taking deadly aim on the high flyers. This means developing the expertise at the examiner level to look at the mismatch, to judge underwriting capability in real estate investment, and to determine that an institution's board of directors really understands what's going on.

If risk-based premiums or risk-based capital standards are adopted, the focus should be very limited. Particularly, the focus should be on restructuring, on real estate investment, and on other nonfinancially related activities only.

What's also needed is for FSLIC to be decentralized to the Federal Home Loan district banks, similar to what was done with the examination function. In addition, more use should be made of innovative techniques for handling failed institutions. Here I refer to consignment management, also the use of strike teams of experts to flush out real estate problems before they explode, and possibly the creation of a government liquidation corporation arrangement to work out the orderly disposition of a failed institution's problem assets using private sector expertise.

If Congress would allow FSLIC to be decentralized, it could move much faster on taking over failing or failed institutions. This would minimize losses to the fund, avoid the throwing of "Hail Mary" passes, reduce the problem of unmanaged real estate assets wasting away, and lessen adverse publicity.

As for private deposit insurance as a substitute for or supplement to federally backed insurance, my quick answer is to forget about it. The casualty industry would never go along with the large single risk for major institutions, nor is the entire casualty industry big enough to insure the thrift industry. Besides, if the private insurers go under, the Federal Government would have to pick up the pieces anyway, which gets us right back to where we began.

I'd like to conclude by saying that the health of the savings and loan business in the United States depends primarily on the volatility and the level of interest rates, at least until S&L's have restructured the asset-liability mismatch on their balance sheets. Until that time, profitability and viability will depend on the nature of interest rate cycles.

The single biggest factor affecting interest rate levels, in my judgment, is the current and projected Federal deficit. So a rapid solution to the deficit issue would ultimately solve most of the problems of thrift institutions and make hearings such as this unnecessary in the future.

Conversely, if the deficit is not reduced, the committee can look forward to many more painful hours of testimony on this and related subjects from diverse witnesses.

I truly appreciate the chance to present this testimony orally. With your permission, Mr. Chairman, I will submit a more detailed

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statement for the record. There is one page, the appendix B of my full statement, which was inadvertently left out. That's available on the table and I've made it available to the committee staff. Thank you, sir.

[The complete prepared statement follows:]

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STATEMENT OF JAY JANIS

Mr. Chairman and distinguished members of the Committee:

My name is Jay Janis, and I was chairman of the Federal Home Loan Bank Board in 1979 and 1980. Since then, I have continued my association with the savings and loan business, first as president of California Federal Savings and Loan Association in 1981 and 1982, and after that, as chairman of the executive committee and member of the board of Gibraltar Financial Corporation. I am also a director of the Federal Home Loan Bank of San Francisco and serve as chairman of its audit committee.

The Committee has asked for testimony on certain aspects of the examination, supervision, and insurance functions relating to federally insured thrift institutions, and you have posed four specific questions for the witnesses to consider. Before trying to answer those specific questions, I want to provide some background on the events that led up to the circumstances in which the savings and loan business now finds itself -- in particular, on the deregulation of that industry.

BACKGROUND ON DEREGULATION

The odyssey of the modern savings and loan business in America rightfully begins during the Great Depression in the 1930s. In the

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'decades following World War II, savings and loans performed the vital function of providing mortgage credit to returning veterans and, following them, to the so-called "baby boomers." It was the era of the long-term, fixed-rate mortgage loan, financed essentially by short-term, passbook savings deposits. For more than 40 years, the regulation of the business could best be described as rigid, and S&Ls enjoyed long periods of relative stability -- and profitability -- until the late 1970s. The advent of the money market mutual funds and the extreme volatility of interest rates at that time were the impetus for massive disintermediation at regulated financial institutions, and this outflow of funds along with certain other political pressures from depositors led to the deregulation of deposit rates by regulation in 1978 and by statute in 1980. As inflation grew to double digits and interest rates rose and remained at unprecedented levels, nearly one-quarter of the nation's S&Ls were forced out of business. (The practice of borrowing short and lending long -- the mainstay of the business for almost 50 years -- was the cause of the demise of perhaps 1,000 institutions.) At this time, in order to allow S&Ls greater opportunity to earn through diversification, the asset side of the balance sheet was largely deregulated as most of the asset investment limitations on S&Ls were rapidly removed, again by regulation and statute, culminating in the Garn-St Germain Act in late 1982.

FLAWS IN THE PROCESS

The deregulation of the savings and loan business that took place during this brief period paralleled the deregulation that was

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occurring in other key industries in the United States, such as trucking, communications, airlines, and financial services. Regrettably, the process of deregulation of the thrift industry was seriously flawed. In the first place, the timing of the liability/asset deregulation was backwards. Asset-side deregulation should have occurred fully five years before liability-side (i.e., deposit) deregulation. In that way S&Ls could have adjusted the mismatch in their balance sheets by shortening the maturing of their assets -- primarily by adding adjustable mortgage loans (AMLs) -- in anticipation of the need to pay market rates for deposits as liabilities were deregulated. Moreover, little thought was given to the orderly planning of deregulation, and few efforts were made to anticipate cause and effect relationships (especially the actions of state legislatures in granting even broader powers to state-chartered institutions). Nor was much consideration given to the so-called public confidence factor -- how to maintain public confidence in the wake of adverse publicity about failing institutions.

Furthermore, the deregulation of S&Ls had the extreme misfortune to have coincided with the worst spike in interest rates that the nation had ever seen. (The inverted yield curve, the mismatch of maturities of assets and liabilities from old portfolios, and the length of time that high interest rates persisted resulted in significant losses for the business and a severe erosion of its net worth.) Worse yet, at this same time, real estate prices began to disinflate as the economy softened, and this turn of events led to delinquencies and foreclosures which made matters even worse.

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A key point to consider is that the deregulation of the financial services industry -- at least as far as insured institutions are concerned -- differs in one major way from the deregulation of trucking, communications and airlines: Namely, that market forces cannot be allowed to decide who survives and who fails. That will remain the job of the regulators. So there is every expectation that more examination rather that less will be needed. This greater emphasis on the regulator's role is not inconsistent with the concept of deregulation, as long as it is understood that deregulation -- at insured financial institutions -- essentially means the right to pay market rates for deposits and greater latitude to make investments, but not unlimited freedom to do so.

Nonetheless, the deregulation of the savings and loan business in America must be viewed as a watershed event, a fundamental break with the past from which there can be no significant turning back. Once the cork was pulled, the genie of deregulation -- with all of its flaws and unfortunate timing -- was out of the bottle forever. We are now in a period of transition, and the restraining efforts that are being taken today by the present Bank Board and Congress should be regarded more as an attempt to mitigate the problems stemming from the rapid pace of deregulation than as an attempt to reregulate per se. This may not be clear right now, but history will make it clear as events unfold over the next decade, although there is no denying that the current spate of restrictive regulations certainly appear to be piecemeal attempts at reregulation. For the last year or so, an intense policy debate has centered on the issue of whether federal

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deposit insurance is compatible with the deregulation of insured financial institutions. I believe that it is, provided the examination and supervision functions performed by the regulators are improved.

THE TRAUMA FOLLOWING DEREGULATION

Aside from the flaws in the way the deregulation process was handled or the unfortunate coincidence of its timing, the fact remains that deregulation, by its very nature, is a type of economic or financial Darwinism. The survival of the fittest means that some don't survive, and that brings its own kind of trauma to the entire system. What has happened is that many older associations were dragged under; several of the recently formed associations began to engage in "exotic" behavior (at least for traditional S&Ls); and a new breed of "get-rich-quick" entrepreneur rushed into the business. In retrospect all of this was predictable; in fact, it may be viewed as the normal workings of the market place, the natural by-product of deregulation, as certain inexorable forces were set in motion. For instance:

-- As institutions were allowed to pay higher, market rates for deposits, funds have flowed in at record levels. This has caused a greater push for investment, and too much money is being thrown at too few deals.*

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*Some institutions in California are so anxious to get their money out

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-- As institutions paid higher rates for deposits, higher yields for investment were required, resulting in greater risk.

-- As federal regulators and Congress granted additional powers to federally chartered associations, many states (notably California, Texas and Florida) rushed to grant even more liberal powers to state-chartered institutions, further increasing the riskiness of many of them, especially those that became little more than real estate development companies.

-- As state legislatures granted greater powers (almost unlimited in California), state charters became very valuable commodities and businessmen new to the industry applied for them. These often turned out to be risk-takers, entrepreneurs looking for a fast buck, and developers seeking lower cost funds for their projects. Direct investment in real estate grew, with all of the predictably greater risks.

-- As older institutions predictably began to slide and net worth eroded, many of them resorted to risky last ditch efforts ("end-of-game" plays or "Hail Mary passes") to stave off insolvency and the supervisor.

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that they are guaranteeing loan approval in three days, funding in ten days, no verifications of income, no verification of employment, and no use of ratios to determine the borrower's ability to repay the loan, provided a 25% downpayment is made.

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-- As behavior became more "exotic" (everything from virtually overnight growth in footings that doubled or tripled the size of an institution to investments in race horse thoroughbreds) and as several institutions failed, there was considerable adverse publicity about the S&L business and the financial soundness of the FSLIC fund.

THE FEDERAL RESPONSE

It was also predictable that the regulators and Congress would perceive a need to deal with these emerging problems by slowing down or, indeed, even reversing the process of deregulation. What has been done so far amounts to a kind of plugging of the dike. For instance, regulations have been adopted to slow growth, limit certain kinds of direct investments and raise the FSLIC premium; also, hearings and studies have been conducted on risk-based insurance premiums and risk-based capital, on a qualified thrift lender test, and on placing limits on liberal state chartering powers. These and other actions that have been taken represent a shotgun approach to dealing with the myriad difficulties following deregulation.

TARGETING ON THE REAL PROBLE

What I think may be emerging finally, however, is greater understanding that S&L problems following deregulation are best handled with a rifle rather than with a shotgun. Put differently, we are finding on closer analysis that there are really only two

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significant problems from a regulatory and supervisory point of view: Interest rate sensitivity risk and credit risk. Those institutions which have not restructured their balance sheets (i.e., improved the match between their maturing assets and liabilities) are the ones with interest rate sensitivity risk. Those institutions which are the "high flyers" (i.e., extremely rapid growth or reckless investment strategies) are the ones with credit risk. And if the lens on the microscope is turned up even higher, we discover that the investments that pose the most significant risks to the insurance fund are poorly underwritten or fee-driven real estate ventures -- direct investments, joint ventures and certain kinds of acquisition, development and construction (ADC) loans. Certainly the focus up to now has been far too broad.

NEED FOR RESTRUCTURING

Restructuring the balance sheet to remove or reduce an institution's interest rate sensitivity risk is especially important at this particular time, not only because current interest rates provide a golden "window" of opportunity, but because of the significant exposure to FSLIC in dollar terms if institutions fail to restructure. Too little attention is being paid to this issue by Congress, the regulators, stock analysts and rating services, and many of the institutions themselves. My argument about the need to restructure is based on the following assumptions:

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* Interest Rates

  Interest rates will continue to be volatile and cycles will continue; further, we are probably close to the bottom of the interest rate cycle right now.

* S&L Mismatch

  S&Ls are interest rate sensitive as a result of their being significantly mismatched; and, except for a small number of institutions, few have accomplished much in the way of restructuring.

* Cost of Restructuring

  There is a direct inverse correlation between restructuring and profitability; that is, the more restructuring that is done, the more it costs in terms of reduced profitability -- in an environment of a positively sloped yield curve.

These assumptions lead me to one conclusion. It is this: At the present time the only sensible business plan or financial strategy for most "healthy" companies to follow is to concentrate all efforts and resources on restructuring -- at the expense of maximizing profits -- because otherwise most companies will be unable to survive the next bout of high interest rates, or if they do survive, they will be in such weakened positions that it won't matter whether they are technically solvent or not.

This message is being ignored by almost everyone, as if interest

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rates will remain forever at their present levels. But is that likely -- given the size of the federal budget deficit, the massive trade imbalance, the questionable collectability of the commercial banks' foreign debt and the growing interdependency of the world economic system? Incentives and disincentives should be employed without delay to force the restructuring of thrift institutions in order to reduce interest rate sensitivity risk.

DEALING WITH REAL ESTATE INVESTMENT

Dealing with the high flyers is equally important, but again the focus must be placed where it belongs -- on the convergence of some institutions' real estate investment activity and overly rapid growth. The problem of rapid growth has been adequately addressed by recent Bank Board regulations, and I will discuss real estate investment in more detail below as part of the answer to the four questions posed by the Committee.

QUESTION I: IN TERMS OF ASSESSING THE CONDITION OF AN INSTITUTION, ARE THERE WAYS TO IMPROVE THE EXAMINATION PROCESS?

When the FHLBB took the landmark step of decentralizing the examination function and liberating it from the counterproductive constraints of Office of Management and Budget oversight and other aspects of the Bank Board's standard federal agency status, it did more to improve the examination process than any other single action it could have taken. Examiners had historically been federal employees, typically young people at a GS-9 level with salaries around

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$24,000. As dedicated as they may be, to send such people into the field to do battle with relatively sophisticated S&L executives or, worse yet, with the new style entrepreneurs who are now in the business is obviously asking for trouble. As the chairman of the House Subcommittee on Appropriations (with jurisdiction over the Bank Board) is reported to have said to Chairman Gray: "Every chairman of the Bank Board has tried to get the examiners off the federal payroll, but in your case, things have gotten bad enough for us to say 'yes.'" Why this approval was withheld until this time is anybody's guess, but the fact is that the examiners now work for the Federal Home Loan Banks, and each district bank can staff up as needed, with respect to both quality and quantity. (The costs of examinations are borne totally by the S&Ls themselves, and this was the case even when the examiners were federal employees.) That this action was taken perhaps 10 years too late does not lessen the potential for future improvement nor dampen the enthusiasm felt throughout the Federal Home Loan Bank system for this move. On the other hand, the building and training of new staff takes time, and no one anticipates overnight results.

As far as improving the assessment of institutions by examiners is concerned -- assuming there are enough of them and that they are well-trained -- two obvious suggestions flow from my introductory remarks. First, examiners should carefully analyze an institution's mismatch to determine the degree of interest rate sensitivity risk. Comparisons should be made with its peer group. Stock analysts and rating agencies should likewise put far greater reliance on this measure of risk. All of them should learn to ask the question: What

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happens to the earnings (and net worth) of a given institution if interest rates spike, say, 200 basis points? Second, examiners should develop the expertise to look in much greater depth at real estate investment activities, and specialists should be made available to examiners, on call, for complicated joint venture or ADC transactions. More important, judgments must be made by examiners about the willingness and capacity of institutions to perform quality underwriting on these types of investments, and where such capacity is lacking, supervisory staff should prevent such investments or loans from being made on the grounds of safety and soundness.

Other measures of an institution's "health" should be employed, beyond such obvious ones as spread and operating income, overhead, net worth, the extent of non-recurring income, and scheduled items. For instance, goodwill and other non-earning assets should be matched against interest-bearing liabilities to determine longer-run viability. Also, an institution's capability to underwrite investments, such as high-yield corporate bonds, needs to be analyzed as a condition for continued participation in that market. Finally, the degree of the institution's board of directors' real understanding of and participation in key policy issues should be carefully scrutinized and evaluated.

To carry out most of these suggestions now would require a level of sound, subjective judgment beyond the capacity of the current examiner staff, but part of the enthusiasm for the decentralization I mentioned earlier stems from the expectation that these and other

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approaches to examinations can be used as the staff is upgraded and enlarged. Similar benefits might well be realized if the Federal Home Loan Bank Board itself were to be removed from standard agency status.

QUESTION II: HOW SHOULD LAWS OR REGULATIONS DIFFERENTIATE BETWEEN SAVINGS AND LOAN ASSOCIATIONS?

Again, building upon the discussion in my introductory remarks about interest rate sensitivity risk and credit risk, the best way to differentiate among institutions is to measure their mismatch, analyze the quality of their existing real estate investments and ADC loans and determine their capacity for underwriting new ones.

If Congress decides to authorize risk-based insurance premiums or risk-based capital standards, it should do so with great caution. The notion of a variable insurance premium structure based on the riskiness of the investment, in particular, is appealing at first glance. After all, shouldn't institutions which decide to expose FSLIC to greater risk have to pay the price for taking the greater risk? As logical as this approach may sound, everyone who has attempted to devise a suitable and honest risk-based premium structure -- as far as I know -- has given up in frustration. (See Prof. Paul Horvitz's superb discussion on why such an approach is doomed to failure in: "The Case Against Risk-Related Deposit Insurance Premiums." University of Houston. Undated) I am convinced that the problems of concocting a full-blown, risk-based capital standard are equally insoluble.

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On the other hand, an experimental program that applied risk-based premiums or risk-based capital standards to a narrow set of investments could make a great deal of sense. As I noted earlier, real estate investment activities have caused the FSLIC the most trouble so far, apart from the legacy of the fixed rate mortgage. Real estate investment, because of its widespread nature, is where the major losses have been -- not on the rare investments in cruise ships, horse sperm banks, windmill farms and the like. Therefore, the use of a risk-based insurance premium or risk-based capital approach would make sense if applied just to these areas. And if political demands require, the risk-base approach might be applied to "non-financial activities," as well. In addition, I would seriously consider requiring both additional capital and greater insurance premiums from institutions that fail to make any progress in restructuring, unless interest rate levels, lack of profitability or other conditions beyond the control of the institution made such efforts infeasible. At the same time a strong incentive for those who have improved their asset/liability match should be provided. Mechanisms such as the "qualifying balance deduction" (QBD) are already in place and can be used for making such changes and for providing such incentives.

Another idea that has surfaced recently is the full disclosure to the public of all aspects of an institution's financial condition including its dealings with its regulator. The theory is that such disclosure will allow the market place to work more efficiently in terms of depositor decisions and deposit flows. Again, I would proceed with caution, because this time the issue is public

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confidence. Once lost, it is very difficult to regain. Depositors depend upon the federally insured deposit funds (FSLIC and FDIC) and the implied Congressional backing. This must remain inviolate, and efforts to turn depositors' attention elsewhere should be viewed with considerable alarm. Market forces cannot be allowed to determine which insured financial institutions survive and which fail. This is the job of the regulators. Our economy -- perhaps the world economy, ultimately -- depends on the stability of our banking system, and we tamper with that at our peril.

QUESTION III: WHEN SHOULD A REGULATOR SEEK TO CLOSE AN INSTITUTION, AND HOW SHOULD A FAILURE BE MANAGED?

The short answer to when a regulator should seek to close an institution is ..."just as soon as the law allows." Experience in dealing with serious problem cases has taught one thing: The longer an institution is allowed to remain in business once it has reached the point of no return (i.e., a point close to insolvency), the greater will be the loss to FSLIC. There are several reasons for this. In the first place the institution is more likely to throw the "Hail Mary" pass. Secondly, as more negative net worth appears on the balance sheet, FSLIC will be liable for greater payouts when a final solution is structured. Third, the asset most likely to be on the failing institution's books is improved real estate, and this is the one type of asset whose value declines precipitously when it is not managed.

Moreover, the quicker FSLIC moves on a case, the more the entire

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system benefits. In addition to the money that FSLIC saves from early action, a rapid response by FSLIC reduces the amount of adverse media coverage and bad publicity. This is vital in terms of maintaining public confidence at home and abroad. The searing lesson learned from the Ohio deposit crisis was the interdependence of the world banking system. That a run on several small, state-sponsored privately insured thrifts could have caused a temporary, but frantic sell-off of the American dollar on the foreign currency market is almost inconceivable. But that is precisely what happened, and once again we were reminded of the essential fragility of the banking system and its almost total reliance on the public confidence factor. I am personally persuaded that the FDIC's relatively favorable image in the public's mind -- despite the fact that its potential problems (e.g., energy loans and loans to foreign governments) are as serious as FSLIC's -- is due to the speed with which FDIC closes insolvent institutions.

In recent times, FSLIC has indeed been extremely slow to take over failing institutions, and so the cost to the fund has been unnecessarily large. The plain fact is that the magnitude of current problems exceeds FSLIC's present capacity to deal with them. Whether this results from an overworked staff, a shortage of funds or something else is for others to say. What is clear is the need for Congress to give the Bank Board the authority it requires to deal with the FSLIC problem. This means the delegation of FSLIC staff functions to the Federal Home Loan Banks, similar to the handling of the examination function. It also means that Congress must relieve FSLIC

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of bureaucratic requirements relating to bidding and other administrative procedures so that new approaches to case management may be tried, and FSLIC must be freed from OMB's heavy hand relative to apportionment requirements resulting from payouts. Within the savings and loan business, FSLIC's inadequacies are becoming more and more controversial.

According to recent testimony by the U.S. League of Savings Institutions, the trade association acknowledges the extra costs in decentralizing FSLIC and -- speaking for the industry -- accepts the extra burden because it believes the cost in the long run would be less than paying additional FSLIC premiums or assessments. In my judgment Congress has no excuse for failing to grant the Bank Board the powers it needs to deal with its FSLIC problems, and in fact some of those powers are already proposed in S.759. FSLIC's problems are correctable, and under no circumstances should a merger between FSLIC and FDIC be seriously contemplated.

The answer to how to manage failing associations is more complex. Since the management of failing associations is a shared responsibility between FSLIC in Washington and the principal supervisory agent at the district Bank (with final authority residing in Washington), a good starting point would be for FSLIC to provide support and encouragement for the efforts of the supervisory staff at the district Banks as they take the lead in handling problem cases and failed institutions.

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The statutes provide a number of standard tools to regulators in dealing with failed institutions. In choosing among these tools -- mergers, purchase and assumption transactions, conservatorships and liquidations -- the Bank Board is required to choose the one that will result in the least cost to the government. As logical as this approach may sound, and as twisted as the accounting may get to prove to the General Accounting Office that the statute was scrupulously followed, it may be that the statutory requirement for least cost may need to be modified so that some of the new techniques that are being developed can be used. I will leave that determination to the lawyers.

In any event, a number of newer techniques have been suggested for handling insolvent institutions, and at least one of them, "consignment management," is currently in vogue in California in the 11th District. Actually, the technique was used some years earlier in the Fidelity Savings (California) and the Biscayne Federal (Florida) cases, but some variations on the original theme are being considered in connection with the current generation of consignment management cases. Another approach that would be effective is the creation of "strike teams" at the district Bank level, under the command of the PSA. These teams, consisting of seasoned real estate lawyers, financial consultants, retired accountants and the like, would be recruited on an ad hoc basis from the private sector and employed on an emergency-on-call basis to go into troubled institutions where the risk to FSLIC is especially great and the complexity of the issues requires special expertise. Such teams of experts could help examiners untangle sophisticated real estate transactions, identify

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early warning signs of impending disaster and close off overly speculative behavior before the situation deteriorated beyond repair.

Another innovative approach for dealing specifically with the troubled assets of failed institutions was put together at Gibraltar Financial Corporation in California. The GFC plan provides for the creation of a government liquidation corporation in Washington (or, alternatively, in each of the districts) to deal with the phased liquidation of assets acquired from failed institutions, using market forces and private sector experts to dispose of assets and deposits in an orderly way. Appendix A presents the Gibraltar plan in detail.

QUESTION IV: WHAT IS THE LONG RANGE ROLE OF PRIVATE DEPOSIT INSURANCE?

Numerous studies have been conducted over the years to determine the efficiency of private deposit insurance both as a substitute for and as a supplement to federal deposit insurance. To the best of my knowledge, none of these studies has produced a positive conclusion. While that does not rule out private deposit insurance forever, several troubling questions quickly come to mind whenever the issue is raised. For instance:

-- Would any private isurer be perceived as strong enough in the public's mind?

-- Can any private insurer possibly charge enough in premiums to withstand the potential losses that the actuarial tables would

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demand? Would any such insurer have the capital to withstand the losses if they actually occurred? More important, assuming risks would be laid off, is the entire casualty industry big enough to insure the S&L business?

-- How can the private insurer rely on regulation and supervision by a federal agency? What if the federal regulator were to grant new powers that the private insurer thought were too risky? What if the federal supervisor were too lax, too slow to move, or just plain inefficient?

-- What if a private insurer wanted to cancel or not renew coverage. Wouldn't that cause a run on that institution? Worse yet, how does a private insurer stop a run?

-- Ultimately, in the case of the failure of the private insurer, who would bail out the depositor?

The answer to this last question -- which is pivotal -- is obviously "the federal government," and for that reason, it would be fair to say that private deposit insurance is an idea whose time will likely never come, at least not in our lifetimes.

CONCLUSION

For better or for worse, the deregulation of America's insured financial institutions is here to stay.

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So is Federal deposit insurance, because retaining public confidence in an otherwise fragile banking system depends on it.

Deregulation and deposit insurance are compatible concepts provided the regulators, and not market forces, determine which institutions survive and which fail.

This will require three changes:

-- Removing the bureaucratic constraints on FSLIC and the Bank Board.

-- Upgrading and improving the examination and supervision process.

-- Focusing the regulators and Congress on the real problems -- the need to restructure (interest rate sensitivity risk) and direct investment in real estate (credit risk).

In the near term, however, the health of the savings and loan business in the United States depends primarily on the volatility and level of interest rates -- at least until S&Ls have restructured the asset/liability mismatch on their balance sheets. Until that time, profitability and, indeed, viability will depend on the nature of interest rate cycles. The single biggest factor affecting interest rate levels, in my judgment, is the current and projected federal budget deficit. So a rapid solution to the deficit issue would ultimately solve most of the problems of thrift institutions and make hearings such as this unnecessary in the future. (See Appendix B for

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my recent article on the long range effects of the deficit on the thrifts, published in Savings Institutions, January, 1985, page 20.) Conversely, if the deficit is not reduced, the Committee can look forward to many more painful hours of testimony on this and related subjects from diverse witnesses.

I thank the chairman and the Committee for the invitation to appear and present my testimony on these important matters.

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APPENDIX (A)

PHASED LIQUIDATION PLAN FOR PROBLEM FSLIC INSURED INSTITUTIONS

INTRODUCTION

A crucial question facing the FSLIC is how to deal with the, perhaps, 200-300 problem cases currently on its books. The problem is that the FSLIC does not have the resources to accept the immediate cost of liquidation, and appropriate merger partners cannot be found at a cost acceptable to the FSLIC. Therefore, the problem continues to grow and is compounded by the fact that the very existence of these associations often has negative effects on deposit rates, lending spreads, and so forth, thus increasing the probability that viable associations will become problems.

The essence of this proposal is to liquidate these companies over time, to minimize the costs to the FSLIC in liquidating them, and to spread the liquidation costs over time so that the losses to FSLIC can be managed effectively. A salient feature of the proposal is to use market forces to move insured deposits from problem cases to viable members of the financial community.

PROPOSAL

The Federal Home Loan Bank and the FSLIC would charter twelve Federal savings associations--one for each of the FHLB districts. Each of these associations would be capitalized by income capital certificates. The terms of the ICC's would give the FSLIC the right to name the board of each new association. Once the board has been named, the board then would have the right to hire personnel and proceed with the subsequent management of its respective association. The sole purpose of each of the newly chartered associations would be the phased liquidation of troubled associations subsequently merged into it. As such, these FHLB-sponsored or "government" associations would, by definition, have a finite life.

Troubled associations meeting existing criteria for liquidation or forced merger would be merged into the new "government" association, which is the successor

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association.* (For expository purposes, we will deal with a single "government" institution below--recognizing that each of the twelve district institutions would operate in the same way.) The merger plan involves the following components:

1. When an association is defined as no longer viable, it would be placed in receivership and merged into the new government association.
2. Once the merger is effected, the following process would begin:
   a. Only those personnel required to provide basic depository and support functions would be retained by the successor institution. All other services (lending, overall management, etc.) would cease and non-necessary personnel would be terminated.
   b. All assets of the disappearing association with market value in excess of book value and not necessary to the provision of depository services would be sold. This sale includes, for example, loans and securities, buildings and leases, equipment, etc. Any branches and deposits which could be sold would be sold. Loan servicing also would be sold, and this would become a valuable source of capital for the continuing liquidation process. In essence, the disappearing association would be stripped down to a core component of assets with market value less than book value and a core group of personnel necessary to provide the remaining depository services.

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* Please Note:

The term "disappearing" association refers to the troubled association that is merged out of existence.

The "successor" institution is a newly chartered Federal association sponsored by the District Federal Home Loan Bank into which the troubled association is merged and is referred to as the "government" or FHLB-sponsored association for the purposes of discussion (although its precise legal status will be determined subsequently after discussion with counsel). Presumably, it would be a private corporation whose stock is owned by the FSLIC.

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c. Depository customers would be assured that not only are their deposits fully insured but that they are now managed by a government-owned savings association and not a "problem" company. This should forestall runs, etc.

d. The above actions would accomplish several objectives. First, operating costs would be significantly reduced both by eliminating most of the activities of the disappearing association and by obtaining economies of scale from the centralization of overall management. Second, cash would be raised. The cash could be used to fund controlled outflows of savings deposits. Specifically, the liability manager of the government association would be instructed to price his accounts sufficiently below market rates to induce depository outflows equal to excess liquidity. In sum, the market process would be used to get deposits out of these problem institutions and into viable components of the financial community.

e. The remaining (below market rate) assets on the books would generate cash flow over time via interest payments and amortization. That cash flow would be used, as above, to fund controlled depository shrinkage. Based on an average loan life of ten to twelve years, the government association would eventually shrink from existence. Moreover, as the interest rate cycle proceeds, windows would occur where assets which were formerly under water would have market value in excess of costs. When those periods occur, the assets could be sold and the process described above could be accelerated.

3. The process might be accelerated further in several ways. First, it might be possible and cost effective to sell branches and deposits on a wholesale basis to viable savings and loans (and banks) by providing the purchasing institution with a note on the government savings association as the balancing item to the deposit purchased. The note could be

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structured to provide a risk-free spread to the purchasing institution--perhaps based on the duration of the deposits assumed. Since the spread would be risk free (i.e., government-sponsored and duration matched), it ought to be relatively small. Moreover, the FHLB additionally might induce associations to participate by waiving the growth regulations for such a transaction--i.e., the growth would be excluded from the new net worth calculations. Second, since the government association is an entity with implied government sponsorship (by virtue of FSLIC's ownership of its stock), it may be able to borrow at favorable rates in the money markets. Such funds could be used via either the market process defined above or wholesale branch deposit sales to accelerate the transfer of deposits to viable institutions (i.e., the cash raised could be used as the balancing item for deposits assumed by viable institutions).

PERSONNEL AND MANAGEMENT ISSUES

The new government association will certainly require a small group of skilled and experienced people for its management. Moreover, the management must have the authority to act quickly and decisively. Among other things, this means the government association should be outside the civil service system and, within the limits of its defined public service task, free from political pressures.

The key to accomplishing these ends lies with the board of directors. Obviously, they must be individuals of the highest caliber. The government must delegate to them the authority to carry out their assigned task without significant interference.

The management of the government corporation could be obtained from the following sources:

a. The management pool freed by the liquidation process;

b. Strong individuals in viable institutions who are nearing the end of their careers and would relish this challenge;

c. Executive "loan" programs from the financial services industry.

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PUBLIC POLICY ISSUES

1. The above plan gets deposits out of non-viable institutions without the necessity of paying the FSLIC insurance claim.
2. Viable institutions would be made stronger and would have a better chance of remaining viable:
   a. General deposit rates should be lowered due to the pricing policy of the government association as well as the removal of problem associations (and their pricing policies) from the marketplace.
   b. General and administrative expenses for all associations should be lowered from the market pressures of individuals entering the labor market. In addition, viable associations could substitute strong individuals from failing institutions for weak individuals currently on their staffs.
   c. By removing a large number of desperate and highly leveraged lenders from the marketplace, spreads should widen and credit quality should increase.
3. As the cost of funds and general expenses decrease in the savings and loan industry, it may be possible to reduce the absolute level of lending rates, even with increased marginal spreads. In short, the consumer may benefit.
4. While this process is designed to minimize the cost of liquidation, it won't eliminate it. There will still be spread problems if the yield curve rises, loan losses, and so forth. However, if one accepts the proposition that solving the FSLIC's current dilemma is going to involve <u>some</u> cost, this proposal, at the least, spreads that cost over a number of years and, therefore, makes it more manageable.

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APPENDIX (B)

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SAVINGS AND LOANS IN THE YEAR 1994: A FANTASY

What if we could see into the future and accurately predict what will happen to the savings and loan business over the next ten years? What mistakes could we avoid? What would we do differently? Would it make any difference? Let's imagine that it is 1994 and that we are there together looking back over the previous ten years.

JAY JANIS was Chairman of the Federal Home Loan Bank Board in 1979-1980. He is currently Chairman of the Executive Committee of Gibraltar Savings of California.

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Good morning. Let me begin by thanking you for inviting me to this magnificant Oregon coast to share with you my thoughts on the state of the savings and loan industry.

This year of 1994 is truly a watershed period for the savings and loan business. As you know, Congress will soon act on a bill that will determine whether our industry will remain as a unique and separate group of financial institutions with our own regulator or be merged with the commercial banks. Today, I would like to discuss with you the events that brought us to this point.

Just five years ago, in 1989, the landmark "Financial Institution Merger Act," or FIMA, set the stage for this action when the three agencies with regulatory authority over the banks (the Federal Reserve, the FDIC, and the Office of the Comptroller of the Currency) were converted into a single bank regulatory agency. This Act left the S & Ls independent, but the two insurance funds, the FDIC and FSLIC were combined. The question now is whether Congress will take the final step to merge the banks and S & Ls, since the two insurance funds have been combined. With respect to charters and powers, the bill currently before Congress also proposes to eliminate the differences between commercial banks and S & Ls altogether, and this, of course, would end the special purpose for which the S & Ls were created some sixty years ago back in 1933 -- that special purpose being to finance home mortgages.

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So here we stand in 1994 at the crossroad, on the verge of the possible extinction of our industry, and it would be useful to understand how we reached such a critical point in our existence.

But before I deal with that, I must interject that I oppose this new bill and intend to work hard to defeat it, and I hope you will help.

This effort won't be easy. After all, as you know too well, today only three hundred S & Ls are left in America; so the Congress has a good rationale for homogenization. Moreover, we lack the political clout we had back in 1984 when we had 3,000 S & Ls to oppose such an action.

Of course, the Savings Association of America -- our trade association -- will be there in our corner as usual. Thanks to the merger some years ago between what used to be called the U.S. League of Savings Institutions and the National Council of Savings Institutions, we now have a unified industry. Of course, the resulting entity is much smaller than it was back in the middle 1980s because there are so few S & Ls left in America. But even though only one lobbyist is left in Washington, let me assure you that she is a good one who is well respected by Congress and the Administration.

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Before I return to my theme and describe how we went from an industry of 3,000 associations down to just 300, I want to say a few words about recent economic events that influenced our present condition.

First, let me state that our nation's progress in reducing the deficit has been noteworthy. Just three short years ago, the annual budget deficit stood at $624 billion. Now it is down to just under $500 billion per year. That is a major improvement, although it is still much higher than the annual deficit of $175 billion back in 1984.

To get the deficit under control -- when all else had failed -- the Constitutional Convention of 1991 was called for just that purpose: to ratify an amendment to the Constitution for a balanced budget, to be phased in over the next 20 years. It is unfortunate that the Supreme Court ruled that the Constitutional Convention could also deal with other issues -- even though the Convention had been called for only one purpose, the Balanced Budget Amendment -- and regrettably as you know the Convention did take up other issues. Given the mood of the country at the time, it was not surprising that some of our civil liberties were eroded -- relating to free speech, illegal search and seizure, and equal protection under the law -- but most people believe it was the price we simply had to pay to bring rationality to the federal economy and to save the nation and, some say, the world.

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After all, spending in both the defense and domestic areas had increased dramatically over the last ten years, and there was a political unwillingness to curb spending or to raise taxes. In fact, it had become political suicide to do so, especially after the 1984 political campaign, which some of you older folks will remember. As a result of that campaign, and in every campaign since, one candidate has accused the other of harboring a secret plan to raise taxes and the other candidate has spent the whole campaign denying it. Since then, no politician has been willing even to consider raising taxes.

But the point is that by the late 1980s we had reached a stage of economic crisis. Congress and the Administration had still not been able to agree on spending cuts; taxes had not been raised; and the funds from the Euromarket, which had been helping to finance our huge deficits in previous years, had dried up. These funds now stayed at home because of high interest rates in Europe which were related to their own inflation and the need to pay for massive increases in the price of oil that had been caused by the continuing destabilization in the Middle East and the reckless policies of the OPEC cartel. As a result of the huge deficit in the United States, the recklessness of OPEC, and the virtual bankruptcy of several third-world nations stemming from their inability to borrow anymore in the world capital markets after several of them had defaulted, the world economy had come almost to a halt.

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Our own situation at home was no better: there were three major recessions over the last ten years due to the extremely high interest rates which the deficits had caused; the economy fell victim to periods of recurring stagnation; and inflation soared into double digits. Some blamed the Federal Reserve for the inflation by having monetized the debt; but what alternative did the Fed have to finance the deficit?

Naturally, the United States was blamed for putting the world on the edge of a worldwide depression (although our profligacy was certainly no worse than anyone else's). And it was during this dark period that our government called the Constitutional Convention to reduce the deficit, which, as we all know, had its price, as I have said, in the loss of some of our constitutional rights. But what else could our national leaders do? They simply had no other choice.

Now with that as our economic backdrop, we can trace the steps that led our industry to shrink to just 300 S & Ls.

The first major "fallout" occurred in the 1980-82 period when we went from 4,200 S & Ls down to 3,000. That was a loss in only three years of close to 30% of the industry. Those that survived that period were generally so weak, in terms of eroded net worth, that when the next bout of high interest rates occurred, the number of S & Ls then shrank by half to 1,500. The third period of high rates took all but 300 of us. And it is the fate of those remaining 300 -- and our industry, as an industry -- that Congress is now deciding.

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But it wasn't only high interest rates that hurt us. If you will recall, the asset deregulation that had occurred in the early part of the 1980s allowed institutions to invest in riskier assets than just single family mortgage loans. The liability deregulation that had preceded this asset deregulation made it absolutely necessary to do so to maintain any kind of a spread at all. As a consequence of all of this, FSLIC nearly went broke during the middle 1980s.

In retrospect, it is inconceivable to us now that those who initiated financial institution deregulation did not foresee the cause-and-effect relationship resulting from liability deregulation; that is, to pay depositors more meant that S & Ls had to take on riskier assets. Had the deregulation taken place the other way around, that is, if the industry had first been allowed to invest in adjustable rate mortgages (ARMs) on the asset side -- before deposit deregulation had taken place -- institutions could have been better matched and might have weathered the storm a lot better. Of course, no one counted on the high deficits which exacerbated the problem, and it may be that without the deficits, the industry could have survived almost intact after the first fallout in 1980-82, since several associations <u>did</u> try to add ARMs to their portfolios in large numbers at that time. Unfortunately, for many of them, because of the deficits during the middle 1980s and the high interest rates, it was too late, and they did not make it.

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Two points about the ARMs are worth making parenthetically at this time:

The first point is that back in the early 1980s when ARMs became popular in our country, although more than half of all new mortgages being originated were ARMs, only about 5% of American homeowners actually had an adjustable mortgage. By 1990, as ARMs continued to be written, close to 70% of Americans had adjustable loans. This jump in the number of American homeowners with ARMs, from roughly 5% in 1984 to 70% in 1990, meant that America had joined Canada, Great Britain and a number of other nations in becoming an ARM nation, and this had enormous political repercussions for very obvious reasons. Each time there was a period of very high interest rates, large numbers of Americans stood in jeopardy of losing their homes.

As a consequence, the "1988 Home Mortgage Forebearance Act" was passed -- in an election year I might add -- which required lenders to forebear on delinquent mortgages when the delinquencies were caused by high interest rates. Earlier Congressional actions had already provided some consumer protection in ARM contracts. But still, the political pressure on the lawmakers from vast numbers of homeowners in jeopardy of losing their homes became a national problem of great magnitude: after all, from a political point of view, there is quite a difference between 5% of the people in jeopardy and 70%. In part, this led to the calling of the 1991 Constitutional Convention on Deficits when

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Congress finally realized that massive deficits meant periods of high interest rates which, in turn, meant very unhappy voters. Back in 1984, when only 5% of the homeowners had adjustable loans, no one cared about the deficit very much, and it was not a potent political issue. Nor were the politicians willing to focus on what the effects of continued high deficits might be. If the politicians had anticipated the problem then, they might have banned ARMs -- which would have been foolish -- or else bit the bullet and cut the deficit, which obviously would have been the preferred course of action. Actually, they did neither.

The second point to make about ARM lending is one that seems obvious in hindsight, but back in the middle 1980s, it somehow eluded many relatively sophisticated S & L lenders. Simply put, many ARM loans were being made at negative spreads, that is, lenders were actually locking in a loss on many of the loans they were originating. This stemmed from their desire, beginning earlier in the 1980s, to make as many variable loans (ARMs) as possible. By adding variable loans in large numbers, they hoped to outgrow the negative effects of all those low-yielding, fixed-rate loans. They realized the error of their ways in the 1950s, 60s, and 70s of borrowing short and lending long. Now they were determined to correct the error as quickly as possible by putting ARMs into their portfolios in record numbers.

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Again, in hindsight, this strategy would likely have worked, had they been able to lock in a positive spread between the cost of their funds and the yield on the loan. But, alas, marketplace competition forced them to lend at rates that actually locked in a loss. Typically, six-month money was costing them about twelve percent. If you add to that the cost of making the loan, the cost of servicing it, the risk factor, and a reasonable return on equity (R.O.E.), you reach a required yield well in excess of 14%. But they were lending at only about 13% (index plus spread), well short of what was needed. And the points they received (usually about two) could not be taken into income, since any amount over actual cost recovery had to be amortized as a yield adjustment over the life of the loan. This last factor, incidentally, may have been part of the problem, in that many S & L executives seemed to be unaware of this accounting requirement or at least ignored it in calculating the profitability of their ARM lending until their public accountants finally cracked down.

By way of a footnote, let me add that in those days lenders enticed borrowers by use of so-called "teaser" rates (an initial payment rate lower than the note rate for, say, six months). This device has come into disuse in recent years owing to regulatory actions. In any event, my point is I have not been using "teasers" in connection with my calculations about lending at a loss.

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Another explanation for why some institutions were lending at a negative spread and locking in losses stems from a misunderstanding of the difference between marginal cost lending (or pricing loans at the margin, i.e., based on the marginal cost of funds) versus average cost lending in which the spread is calculated on top of the average (historical cost) of funds. The fallacy in this latter approach is that for every asset that is added with a certain yield, there must be a corresponding liability put on the books with a certain cost. Average or historical-cost pricing ignores the liability that is incurred to finance the transaction.

Remembering back to those years, I have often asked myself why no one in the financial press, or the stock analysts, wrote about these two points I have just made about ARM lending. I remember, for instance, The American Banker, back in the 1983-85 period, writing story after story about "duration matching," for example, a concept that proved totally irrelevent to the thrift industry as time and events unfolded. Or certain stock analysts extolling in their printed reports those companies that made ARMs, oblivious to the negative effects of locking in losses. Certainly, originating ARMs in lieu of fixed-rate loans was the prudent course of action, as events have proved, but the analysts should have been counseling their readers about the dangers to their balance sheet of adding assets with a built-in loss. They should have told them that this was not the way for an S & L to grow out of its problem. Why they failed to write about these points is anybody's guess, but enough about ARMs.

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It is also inconceivable to us now that the people who deregulated our industry beginning some 15 years ago, did not see the basic incompatibility of deposit insurance -- a government guarantee -- in a deregulated world. How could S & Ls pay what the market demanded and not have to invest in riskier assets, with the FSLIC in effect backing our depositors -- and really us? Especially when it became clear, following the Continental Illinois National Bank case and in several other serious ones since then, that the government could not allow large financial institutions, be they banks or S & Ls, to fail because of the fragility of the world financial structure which was exacerbated by the size of the U.S. deficits. Once this basic incompatibility was recognized -- the one between deregulation and deposit insurance -- all kinds of changes of a reregulatory nature, in fact, did take place which the savings and loan industry pushed for and backed, a fact that some outside our industry considered somewhat ironic. The fact was that we found out that some reregulation, although it was distasteful, was necessary. We all came to understand that the giant California S & L back in 1984 that got into trouble was not reined in by the marketplace, but by the regulators: specifically, the SEC's financial disclosure requirements and the FHLBB's limitations and supervisory hand. Some were even heard to repeat a remark in 1985 that had not been heard since the "good old days" of Reg. Q about needing reregulation to save us from ourselves.

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activities that provided high yields and larger spreads.

By now, I hope I have been able to explain how we have reached this watershed period for our industry. The fact is that it was not one cataclysmic event that occurred suddenly that explains it; rather it was a whole series of events over the last ten years from 1984 to now that changed the nature of the savings and loan business which accounts for our present precarious situation.

In addition to those I have already mentioned, a number of other changes have occurred that have adversely effected the savings and loans. Let me briefly mention just a few that have been particularly harmful:

First, there were the significant accounting changes that resulted from the recommendations of the infamous "Commission on Public Accounting for the Thrift Industry." In its landmark report in 1989, the Commission recommended that regulatory accounting procedures (RAP) be eliminated over a four-year period and that mark-to-market accounting be required for thrifts on a phased-in basis over ten years. Both of these recommendations have reluctantly been implemented by the regulator because of the pressure that was built up as a result of the work of that blue ribbon Commission. In addition, a number of important changes were recommended in generally accepted accounting procedures (GAAP), as applied to the thrift industry. For instance, the

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ability to book profits over the short run was circumscribed for a whole host of transactions. In brief, the "profits today / pay tomorrow" approach was curtailed and the public accounting emphasis was placed on building income streams.

Second, there were changes of an adverse nature that resulted from the merger in 1989 of the FSLIC and the FDIC which I mentioned earlier. As we all know, this merger was necessary to keep the FSLIC fund from becoming insolvent. (The interet rates resulting from the deficit and the riskier assets that were put on the books were a double whammy that almost bankrupted the fund.) But the merger with FDIC led to these four important changes: 1) the variable FSLIC insurance premium structure (which this industry so rigorously but unsuccessfully opposed); 2) the one-time special assessment on the remaining S & Ls, and a general increase in the price of deposit insurance resulting from the decision to use private sector-orginated actuarial computations; 3) the implementation of fractional deposit insurance -- insuring only the top portion of jumbo CDs; and 4) a change in the way S & Ls were regulated, now that the FDIC was de facto in charge on the insurance side.

Lastly, there were changes in the operations of the Federal Home Loan Bank system that had a negative effect on savings and loans. For one thing, the U.S. Treasury was forced to put significant restrictions on the FHLB system's ability to go to the market with consolidated obligations, given the Treasury's own enormous need to finance the deficit. This put a severe

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A third conventional wisdom to fall by the wayside was that banks and thrifts would become homogenized because of the new powers given to the S & Ls back in the early 1980s. That homogenization may come true, but it will be for a different reason. It will occur because so many S & Ls were eliminated over the last ten years as a result of the prevailing economic forces, but not, as predicted, because of the new powers they were given or the normal workings of the marketplace. Mortgage finance and housing did turn out to be the glue that held the system together after all.

Finally, speaking of real estate, another conventional wisdom to bite the dust was the widely held belief in the early 1980s that real estate prices would continue to appreciate as they had in the 1970s. But subsequent changes in the tax laws relating to the mortgage interest deduction and tax sheltered syndications had the effect of materially lowering the rate of appreciation of both residential and commercial properties, so that real estate prices for most of the decade lagged behind inflation generally. As a consequence, the so-called "growing balance" loans that characterized so much of the lending especially during the first half of the 1980s were subjected to extreme pressures and foreclosure rates rose to unacceptable levels.

No, these have not been normal times. In summing up these last ten years, it is crucial to understnd that there was one overriding factor that made everything else pale by comparison; one problem which, had it been solved early on, would surely have

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made everything I have described turn out differently. Of course, I refer to the huge and growing deficits that were allowed to build during the 1980s before they were finally reversed in 1991. That was the pivotal issue.

Looking back to late 1984 and early 1985, after the presidential election, we now clearly see this was the point of no return for the deficits. It was the last chance. That was the time to have taken action. After all, after the election the politicking was over, although in truth, the deficit should not have been a political issue anyhow. Both the Democrats and the Republicans had contributed to causing the problem to begin with.

But the nation did not act responsibly then, and the deficit problem went unresolved. If there was one thing we could have changed about the past, it would be that. And now that the nation has finally acted, we recognize that the failure to act earlier came at an enormous cost -- to our basic freedoms, to the welfare of our people, and to the continued existence of our industry.

Let us work hard to defeat the bill before Congress that would merge our industry with the commercial banks. And after we have won that battle, let us hope that we have the good sense to avoid repeating the mistakes of the past, in particular the tragedy of allowing our nation to tolerate such massive deficits. The events of the last ten years should demonstrate the great danger of inaction on such a vital economic issue. The superb political system that took this nation 200 years to perfect hung by a thread. Our liberty and our democratic system is too precious to us all to allow that ever to happen again.

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The CHAIRMAN. Thank you, Mr. Janis. On that last point, I couldn't agree with you more and I've said it many times, I said it back in 1982 and continue to say it, that no matter what we do here legislatively, whether it's more Garn bills, whether it's deposit insurance reform, the fundamental problem lies with our inability to come to grips with the fiscal policy of this country. We're going through the same machinations again right now where we're trying to come to grips with it.

But don't you feel that, even if suddenly, magically, we solved our budget crisis and the House and the Senate got together on a compromise far bigger than we're even talking about, there still is a need for taking a look at deposit insurance and restructuring it to meet current conditions? Even if we solved the current problem of the thrifts as far as the large number of institutions that are in trouble?

Mr. JANIS. Yes, Mr. Chairman, I do. The deficit solution would represent a kind of a longrun fix for the savings and loan business. There are other structural issues that need to be looked at.

CAUTION ON RISK-BASED PREMIUMS OR CAPITAL

I would caution the committee, however, to go very slowly on this issue of risk-based premiums or risk-based capital.

The CHAIRMAN. Jay, you know very well that we never do anything rapidly around here. You don't have to caution us. It will take us far longer than any of us want it to.

Mr. JANIS. It's one of those ideas, Mr. Chairman, that looks great on the surface, but when you try and actually put it on paper, it becomes very, very difficult to do. There are just an enormous set of problems with implementing it, but I think it's worth trying on a narrow and limited experimental basis in the two areas that I suggested—one, getting at this asset-liability mismatch, getting institutions to restructure if you will; and the other is to directly focus on that area of direct real estate investment. That's where I would aim the rifle of risk-based premiums and/or risk-based capital.

The CHAIRMAN. So you would completely agree with Chairman Gray that direct investment is the biggest problem?

Mr. JANIS. As a matter of practicality, there's no question about it. That's where the losses have been. That and the unwillingness or inability of institutions to restructure the mismatch in their portfolios. Those are the two real big problems. But in terms of asset investment, which Chairman Gray was talking about, absolutely. It's poor underwriting as related to direct investment in real estate and point-driven transactions.

The CHAIRMAN. Mr. Pratt, getting back to risk-related premiums or risk-related capital, you made a comment that I agree with. We call them different things. There isn't a great deal of difference, yet we've had people testify that they are for risk-related premiums but not risk-related capital or vice versa.

Would you go into that in a little more detail because it seems to me that you end up with the same result? You are evaluating risks. You're the first person who said that there really isn't a great deal of difference.

Mr. PRATT. Well, I think that they have generally the same effect. I think there are some differences. I think that risk-related capital provides a little more conservative approach to the problem inasmuch as you're requiring the risk takers, the equity owners, to put money there up front which is subject to loss if the activity doesn't work out well; whereas, with the risk-related premium, you're merely taking part of the rent from that higher risk activity as time goes by.

I think that risk-related capital could provide a little more conservative behavior, and I'm reluctant to use that word given the earlier discussions.

The CHAIRMAN. Well, the liberal Senator D'Amato has left, so you can use it if you want to.

Mr. PRATT. I think they do have the same effect and clearly institutions will react to that to some extent. Also, as more capital is there it allows for more risk taking, but when there is nothing to lose, which is the case in hundreds of thrift institutions today—when there is nothing to lose, then an automatic seeking of the highest risk with the highest potential return is really in a personal sense a very rational activity for these institutions. And we simply can't let the system continue to grow on that basis. There has to be some cost of risk bearing and it should reflect the risk bearing.

The CHAIRMAN. Jay, you made the comment that we should pursue this although it's very, very difficult to devise the formula that you set up.

Do you think it's impossible?

Mr. PRATT. I think something beats nothing all to hell, and people that are saying that it's so difficult to a large extent are the academicians or people who have a vested interest in not seeing it occur. The system at the present time is so totally arbitrary—that is, it doesn't consider risk at all—that anything which only in a beginning sense and marginally moves to incorporate these activities—it doesn't have to be perfect, it only has to be a start—is going to be an improvement over the present approach.

The CHAIRMAN. Jay, how do you feel?

Mr. JANIS. Mr. Chairman, I don't think it's going to fix an awful lot, even if you develop a risk-based premium or risk-based capital approach. I truly don't. I think it will help people to get over the inequity of the present system, and there is inequity in the present system, but a risk-based approach isn't going to fix an awful lot.

How do you fix the premium? If the premium is too low, it won't have any effect. It won't cause people not to take risks adverse to the insurance fund. If the premium is too high, what you've really done is reregulate through the insurance process and I really don't think that's what you want to do.

To set that premium just right is a very, very tough piece of business.

Mr. PRATT. Mr. Chairman, could I just comment? I guess Jay and I have a pretty substantial disagreement on this, and as I read what he's saying then, you need no capital in an institution because if it's not there to bear risk I don't see any other purpose for it. I think that capital serves a very useful purpose and that entrepreneurs and owners should have some of their own money on the

line and if they have money that they can lose they are going to behave differently than if they don't.

Right now we have a risk-based capital. It's just that the capital is the same for all risks. But I still assume it's there for risk-bearing purposes.

ELEMENT OF FAIRNESS NEEDED

The CHAIRMAN. Jay, let me ask you this question. Isn't the element of fairness rather important because we get back to that prudently run institution, why should they be paying for the ones that are out there taking a great deal of risk?

I mean, we talk a lot about fairness in Congress and it seems to me it's worth at least pursuing and trying to come up with a better system than just saying regardless of how you operate your institution you're going to pay the same rate.

Mr. JANIS. You're right, Senator. I think you should pursue it. I think you should experiment with it. I think you should come up with a program that focuses narrowly on the things that I mentioned before, real estate investment and the mismatch in portfolios. But my advice is not to try to create some broad system of risk-based premium or risk-based capital that covers the waterfront.

You know, the hardest judgment to make, in my opinion, is the ex ante judgment, the judgment made before the fact. Now, 5 years ago, loans to Mexico would have looked terrific. Right now, they don't look so good. Loans for energy, for drilling for proven oil resources 5 or 7 years ago would have looked wonderful. They don't look so good today. So it's a matter of trying to determine really where you know the risk is and where the risk will be and targeting just on that.

So, yes; I think you should pursue it, but I think you should pursue it understanding that it's not going to fix the system, but it will fix the imbalance in equity that you mentioned. Yes; it will do that. That's worth doing, but on a limited basis.

The CHAIRMAN. Well, I suppose that I fall more on Chairman Pratt's side because I happen to think from my experience that money is a very good incentive for doing business. Let me give you an example. Several years ago, when we talked about increased disclosure, you can't imagine the number of financial institutions that came in to me and said, "Look, we don't mind the new regulations on financial disclosure as long as they don't take place for 6 months to 1 year." And I said, "Well, then, what you're telling me is that you want to go dump some bad loans. You want to get rid of them. You want to readjust your portfolio before you disclose." They said, "No, that isn't what we're saying." I said, "Yes, that is exactly what you're saying. That's exactly what you mean. When you get your act cleaned up, then you're perfectly willing to disclose."

I happen to think that when they say if we do this it's going to cost us a lot more money, it really provides an incentive for them to make more prudent decisions.

I think we'd do a lot better job in pollution control in this country if rather than enacting so many ridiculous rules and regula-

tions that cost so much, we said to people, "This is the standard of air quality. You will not violate it. How you stay under it is your business but if you go over it you're going to pay a big fine." I think you would be amazed at how much cleaner the air would get much more rapidly than arguing with EPA.

Maybe I'm wrong, but I think that if it's going to cost you something you're going to try and avoid it. Beyond the element of fairness, I don't know how to approach it, but you can't leave it entirely to market discipline. Ed Gray can't devise enough regulations to control it without getting into what Dick talked about. You're just out there as the local manager for the Federal regulatory agencies and somehow I think we've got to provide an incentive within market discipline for them to clean up their own acts.

I don't know the answers yet. Maybe it will become too complicated to do, but at least at this point I don't think so. I think it's something we ought to pursue very seriously.

Mr. JANIS. Well, I agree with you, Mr. Chairman, and my only admonition would be that you stick to what the real problems are on a narrowly focused basis instead of trying to develop some broad brush insurance risk-based structure that some outside group comes in and tells you will work. Whoever said earlier this morning among the committee members that the insurance industry has been dealing with this kind of risk, I don't think they understand the insurance industry. Financial institution risk is a whole new ball game and the insurance industry has not been dealing with this kind of risk and it's just as neophyte in trying to approach it as anyone else.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Before I get into questions, I want to say to Mr. Janis, I appreciate very much your appendix, too. This is a fantasy, a speech that you were giving in 1994 in Oregon on the Pacific Ocean and you predict in effect what's going to happen in the next 10 years. You see a merger of the trade associations for savings and loans and they're left with only one lobbyist, but as you say, she's a good one. Then you go on to say that,

> Our Nation's progress in reducing the deficit has been noteworthy. Just 3 short years ago the annual budget deficit stood at $624 billion a year. Now it's down to just under $500 billion a year.

And I think that's a pretty good forecast and, of course, as you point out, has had devastating effect in the next 10 years on the industry.

Finally, you point out that there's been a shrinkage in the number of savings and loans. You say the first step was in 1980–82 when you dropped from 4,200 to 3,000, 30 percent attrition, and then the next high interest rate cut you down to 1,500, and as you speak in 1994, there are only 300 left. So it has its element of gloom but it's a delightful fantasy. My fantasies are a little different than that, but I suppose that's the kind of fantasy that an exhead of the Home Loan Bank Board would be expected to have, as his age advances.

I'd like to ask both of you gentlemen, both Mr. Pratt and Mr. Janis the same questions. I'm going to go over these questions very

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quickly so you'll be prepared to think about them. I want to base it on the fact that we learn best from our mistakes.

VIEW OF PAST MISTAKES

With that in mind I'd like each of you to list the following: First, the greatest mistake you made when you were Bank Board Chairman; second, the greatest mistake you think your fellow panel member made when he was Chairman; third, the greatest mistake you think Ed Gray has made so far; fourth, the greatest mistake the Senate Banking Committee made with respect to the savings and loan industry when I was chairman from 1975–80; and finally—this will really put you in the doghouse—the greatest mistake the Senate Banking Committee made with respect to the savings and loan industry during Senator Garn's chairmanship.

Now I'll start off with Mr. Pratt. I thought you ought to have a little choice in the candy store you're visiting, as Mr. Janis put it. First, what was the greatest mistake you made when you were Bank Board Chairman?

Mr. PRATT. I think that while none of them were great, some of them were good. There were two of probably equal magnitude. One, was the failure to truly appreciate the fact that we had standards which required almost zero capital and immensely high leveraging; and two, to not move much more aggressively to improve the management information system and to incorporate current value accounting and really understanding the value of institutions.

Senator PROXMIRE. Very good. And what was the greatest mistake that Mr. Janis made, in your view?

Mr. PRATT. I don't think he made any great ones either. If there was a set of mistakes that might be pointed to prior to my tenure, I guess it was our collective failure to realize the path of erosion of the financial strength of the thrift industry that was occurring through the restriction of assets and the inability to allow some flexibility. And I would put that in your category also, Mr. Proxmire.

Senator PROXMIRE. I appreciate your frankness.

Now how about Ed Gray? Let's dump on him a little bit.

Mr. PRATT. I think he should have stayed with cheese sandwiches instead of tuna. [Laughter.]

Senator PROXMIRE. I won't let you get away with that. Come on, you can do better than that.

Mr. PRATT. I think there's inevitably some transition time required and while it was not Mr. Gray's mistake, perhaps given the magnitude of the problems that were occurring, it was unfortunate in the transition time that it takes for an agency to change hands and for a new regulator to be fully up to speed on the issues he has to deal with.

Senator PROXMIRE. Now you've already mentioned one minor shortcoming during my chairmanship. What else?

Mr. PRATT. I would certainly have no other criticisms.

Senator PROXMIRE. Well, you're a man of fine judgment.

Mr. PRATT. I think there was a failure to recognize on the part of the Congress and the regulators the importance of market forces, the importance of letting the market system allocate resources, and

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there was a period under which the institutions had done relatively well, built up a lot of capital, and I think we eroded that by some misguided social policies and that perhaps also represents my own bias.

Senator PROXMIRE. Misguided social policies in banking?

Mr. PRATT. Forcing institutions perhaps to be more committed to long-term fixed-rate loans when they really did need some portfolio matching, not allowing flexibility for more access to the capital markets in terms of longer term liabilities, this sort of thing.

Senator PROXMIRE. And your good friend, Chairman Garn, the last 5 years?

Mr. PRATT. Well, that's even more difficult, of course, inasmuch as I'm a constituent of his State by inclination.

The CHAIRMAN. You're in the private sector now. You can say anything you want.

Mr. PRATT. I really didn't come here prepared to evaluate people's shortcomings, least of all the chairman's.

Senator PROXMIRE. Well, I don't ask you to evaluate his shortcomings. He has very few. But he's made a mistake or two maybe—maybe he hasn't, maybe the committee has without intention.

The CHAIRMAN. If you really want an answer, you should invite my wife in to answer. [Laughter.]

Senator PROXMIRE. What has the committee done in the last 5 years that you think was a mistake.

Mr. PRATT. Well, I was extremely pleased, I must say, the period I have to reflect back upon, my dealings both with yourself, the chairman and others, I thought the committee was immensely responsive. So this is a very difficult problem for me. I thought we had major needs and I expressed them to the committee and I got, I thought, tremendous bipartisan support. So I really do have a problem with that in both cases.

Senator PROXMIRE. Jay, the greatest mistake you made when you were Bank Board Chairman?

Mr. JANIS. Senator, I've testified before you many times as Chairman of the Bank Board and as Under Secretary of HUD and this is the first time I've ever seen a slightly sadistic tinge to your questioning. I've always enjoyed testifying before you.

I'm going to take them all at once if I may.

Senator PROXMIRE. All right. That's fine.

Mr. JANIS. I was too slow to deregulate. Dick Pratt was too fast to deregulate. Ed Gray was too broad in slowing down deregulation. The Senate Banking Committee was too backwards in the way they went about it under your tenure—that is getting the liabilities ahead of the assets—and the present committee under Senator Garn was too slow to realize the problems that deregulation has caused.

On that latter point, just a quick little thing, this committee I believe needs to free up FSLIC and get it out into those district banks just as fast as you can. It sounds like a little thing, but I really believe that we can make this thing work and FSLIC can work a lot better if you give them the wherewithal to do it. This notion of merging FDIC and FSLIC I believe is an abominable idea. I think FSLIC can be made to work.

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S&L'S FUTURE AS SPECIALIZED HOUSING LENDERS

Senator PROXMIRE. Mr. Pratt, it's been argued by some that the thrift industry really doesn't have a future as specialized housing lenders. They say that the industry can never recover from the losses it has incurred. The only real solution is to merge with commercial banks.

I'd like you to comment on that pessimistic view of the long-term prospects of the savings and loan industry. Is it right or wrong?

Mr. PRATT. I think you can't characterize the industry. I think a third of the industry has excellent potential, is very successful, is well-managed, is well-capitalized, is very forward-looking, and unless it is dragged by other forces will play a successful and prominent role in our financial future.

I think there's a portion of the industry that financially is beyond repair. So it really is a very divided industry and it has a lot to do with how individual institutions came out of the 1981–82 period.

Senator PROXMIRE. So you share part of that Janis fantasy that there will be a sharp diminution, maybe should be at least, in the number of savings and loans?

Mr. PRATT. Yes; I think there will be. I think it's inevitable and I think a major attempt to try and retard that would be very destructive of the better institutions. I think you simply can't go through deregulation without having quite a substantial attrition in the number of institutions. Even if the problems weren't there I think that would have occurred.

Senator PROXMIRE. Mr. Janis, would you comment?

Mr. JANIS. Would you mind restating the question, Senator? I'm not sure I got the focus of it.

Senator PROXMIRE. It's been argued that the thrift industry really doesn't have a future as specialized housing lenders. The industry can never recover from the losses it incurred. The only realistic solution is to merge with commercial banks. What's your comment? Right or wrong?

Mr. JANIS. I strongly disagree with that contention. I believe that the purposes for which the savings and loans were created some 50 years ago by the Congress, still exist. The need for housing is still great in this country. The need to finance it is there and the savings and loan industry has proven over the last 50 years that it can do that job better than any other set of institutions that we have in our Nation.

Senator PROXMIRE. But you still foresee, if your fantasy is anything but just pulling our leg, a diminution in the number of S&L's?

Mr. JANIS. Yes; I do. Of course, the fantasy was written in order to try and point out the fallacies of not taking certain actions beforehand, especially solving the deficit problem. I don't truly believe that there will be 300 institutions in the year 1994, although in my fantasy I indicated they would be very strong ones, those that did survive.

Yes; there will be some diminution. There has to be. Possibly a third of the industry today is not viable and probably cannot be

saved. Fast action by FSLIC on these associations will absolutely reduce the cost to the fund and that is imperative.

Senator PROXMIRE. Thank you, Mr. Chairman.

The CHAIRMAN. Gentlemen, considering the nature of Senator Proxmire's questions, I think we all came out rather well. I'm not sure that if we were in private all the answers about each other would be the same, but nevertheless, we survived that line of questioning.

We do intend to pursue this next week and in September. I would expect that we will have quite a number of questions we would like both of you to respond to in writing as we get more into this because there's a lot of detail that we will simply never have the time for in this type of a hearing. We value both of your backgrounds and experiences as former chairmen and will be calling on you over the next few months again, possibly even to come back and testify as to what type of legislative solution we need to come up with at the end of this process.

We thank you both very much for being here today.

[Response to written questions of Senators Garn and Proxmire follow:]

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JAY JANIS

Chairman of the
Executive Committee

QUESTIONS FOR JAY JANIS FROM SENATOR CARN

Q. 1. What is your view of the National Council Task Force's proposal for risk-based net worth and a definitive time frame for an institution to come into compliance, or find a merger partner, or be placed into receivership?

A. 1. There is no question the savings and loan business needs more capital, and to that extent, the National Council's plan is headed in the right direction. However, the plan might create other problems. For one thing, if the CAMEL bank rating system is used, too much examiner subjectivity might result. I would prefer a system leaning towards objective criteria. Furthermore, the requirement for a definitive time frame or "time certain" might produce perverse results in that institutions could be tempted to throw the "Hail Mary pass" if management perceives the institution will not be able to meet its capital requirement at the required date, absent some windfall.

Q. 2. With regard to the proposed asset management subsidiary, is the real advantage the ability to manage problem assets outside the ceiling of federal pay caps? Isn't a disadvantage that the value of such assets would decline if they had to be disposed of on a stand alone basis - as opposed to being in a package of good assets and solid customers to be sold as a going concern? What are the pros and cons of one asset management subsidiary versus twelve?

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A. 2. The real advantage to the 406 Corporation is the ability to handle difficult and complex real estate workouts by utilizing the expertise of the private sector. The issue is not just pay caps but rather such things as numbers of people (government head count), requirements for bidding vs. negotiated workout contracts, and so forth. By the time the 406 Corporation acquires the problem assets from FSLIC, the latter has done everthing it could to work out a solution including packaging of good and bad assets, so that is not really an alternative. In any event, there is likely to be greater recovery if private sector builders work out problem assets rather than a government agency. A single asset management subsidiary is preferable to twelve because of the overhead savings and the opportunity for consistency in the way the operation is managed across the country. These benefits outweigh the value of decentralized operations (which could be achieved, in any event, by a single subsidiary with field offices).

Q. 3. If a substantial amount of the Home Loan Banks' assets consisted of loans to the FSLIC, could this severely lessen the willingness of the private sector to invest in a Home Loan Bank's debt instruments? Why or why not? Currently what is the total excess debt capacity of the regional Home Loan Banks?

A. 3. The market has already reacted to the possibility of Federal Home Loan Bank system's advance to FSLIC. It is not likely that the total requirements of the 406 Corporation's operations will require excessive issue of consolidated obligations. Excess debt capacity is an unknown.

Q. 4. At what point would loans from the Home Loan Banks begin to impair the confidence of the private sector investors in the Home Loan Banks' debt obligations?

A. 4. No one really knows at what point private sector confidence in the home loan banks might be impaired as a result of debt obligations. My guess is we are a long way from that point. Besides, the FHLB system is just that--a system. It includes the Bank Board, the FSLIC, the District banks, and the savings and loan business. To the extent that all of the parts are relatively healthy, confidence in the system will remain high.

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Q. 5. The primary supervision of thrifts has already been delegated to the local Federal Home Loan Banks. If the disposition of problem institutions were also delegated to the local banks, what would be left for the Bank Board? Wouldn't there be a danger of the Bank Board losing control?

A. 5. The only function of the FHLBB that would be removed as a result of the formation of the 406 Corporation would be a piece of what FSLIC is currently responsible for within the FHLBB structure. All of the other regulatory functions remain plus the additional responsibilities that the Bank Board would have to retain general control of the 406 Corporation.

Q. 6. Should the FSLIC require its insureds to make a one percent deposit in the fund? Why or why not?

A. 6. No. The plan is too costly and the accounting impact on a one-time basis would be too great. If FSLIC were to borrow the funds, this would not help either because FSLIC essentially does not have a cash-flow problem. Moreover, by virtue of the current special assessment, the savings and loan business is, in fact, recapitalizing the FSLIC fund right now.

Q. 7. If the FSLIC and the FDIC funds are not merged, where will the FSLIC obtain sufficient funds to deal with its problems over time?

A. 7. Assessments, income from the portfolio, and stretching out the "hit" to FSLIC by various consignment management and holding devices should provide sufficient funds for FSLIC to deal with its problems over time. The various constraining regulations adopted by the FHLBB over the past year should prevent FSLIC losses from increasing to any significant extent.

Q. 8. With regard to other forms of market discipline by uninsured depositors and general creditors, it is argued that the market discipline is fickle, is trendy. Indeed, it is argued that a run is the ultimate form of market discipline. How do you respond to these concerns?

A. 8. A run is panic usually based on a rumor, which is usually false, and in any event is dangerous to the fragility of the banking system, the national, and even the world economy. Regulators must do anything necessary to prevent runs. If uninsured depositors--meaning wholesale jumbo investors--decide not to rollover their CDs, it is usually because the problem at the institution has already occurred. Therefore, the so-called "disciplining" effect does not work because it is after the fact.

Q. 9. Should the FSLIC be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed bank with any profit after administrative costs arising from the transaction returned to the original stockholders?

A. 9. Yes, if it means saving the government money and if there is sufficient immunization from legal action from stockholders and others. The conventional wisdon of wiping out stockholders at takeover is a notion whose time has come and gone. Nonetheless, finding the "precise moment" is not an easy undertaking.

Q. 10. If the burden of mismanagement was placed squarely and directly on the managers and stockholders, is it necessary to punish depositors and borrowers in order to achieve an improved supervisory system? If failures were handled through a purchase and assumption or forced merger at an earlier stage, regardless of size, wouldn't this dispose of the fairness question as it relates to large and small institutions?

A. 10. This is a good idea conceptually, but tough to work out in practice.

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Q. 11. In your opinion, what are the advantages and disadvantages of risk-based capital and risk-based premiums? Should we consider one or the other or both?

A. 11. I prefer risk-based capital because it provides a double benefit: it discourages exotic behavior and at the same time, it could bring more capital into the industry. Although risk-based capital and risk-based premium approaches would be difficult to put into practice, I would favor a trial of risk-based capital on a limited basis where the designated asset investment are certain types of real-estate activities. Another benefit of the risk-based capital approach is that it exists only for the duration of the specific investment as opposed to the premium approach which is forever.

Q. 12. There appears to be strong support for risk-based capital in some form. Some suggest an adoption of risk-based capital by the federal insurance agencies would give them the necessary authorities to regulate the activities of state-chartered institutions without granting the authority to override a state legislature. What is your view?

A. 12. I am in favor of a risk-based capital experiment. I am also in favor of curtailing unlimited state powers. Unfortunately, the first won't accomplish the second in practice because I doubt that the capital requirement, as a practical matter, would be set high enough to prevent the high flyers from proceeding. Moreover, if they do obtain the capital, they could get themselves into a deal that could take down the entire association.

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Q. 13. How would you recommend resolving the dilemma to the dual banking system created by states authorizing activities which place the federal insurance agencies at risk?

A. 13. There are many aspects of the dual banking system which historically have been meritorious. But what some states, such as California, have done, is reprehensible in terms of the grant of unlimited powers. The reason California and perhaps certain other states have granted such extraordinary powers is that the politicians, for whatever reasons, do not want to lose their state-chartered associations. Accordingly, I would require that the politicians pay the costs--that it share the risk--for their state-chartered institutions that get into trouble as a result of having unlimited powers. I refer here specifically to a state indemnity fund on top of (not replacing) the FSLIC fund. If California tax payers are put at risk, the politicians will be held accountable and behavior (i.e., unlimited state charter powers) might be altered.

Q. 14. Do you believe that the FHLBB and/or FSLIC needs increased enforcement authority? If so, in what areas?

A. 14. Yes. I favor some additional powers for the FHLBB in the area of temporary cease-and-desist orders and when the books and records of the association are in disarray.

Q. 15. Does the Community Savings and Loan and EPIC problem reinforce the need for certain activities to be engaged through a subsidiary of the holding company rather than a subsidiary of a depository institution?

A. 15. As far as the savings and loan business is concerned, given the strictness of the S & L holding company requirements, this question is irrelevent. The EPIC problems would not have occurred if the Maryland fund had adopted the FSLIC safeguard.

Q. 16. How can or should we determine if the size of the insurance fund is sufficient and will continue to be sufficient to assure confidence and manage the costs of potential failures?

A. 16. I don't think anyone knows the answer to this question. Trial and error is probably the best approach.

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QUESTIONS FOR JAY JANIS FROM SENATOR PROXMIRE

According to the Bank Board, there are over 400 savings and loan associations that are insolvent under generally accepted accounting principles. These associations have combined assets of over $100 billion. It has been estimated that the loss to FSLIC would be at least $15 billion if these associations are liquidated. I would like each member of the panel to answer three questions:

Q. 1) If nothing is done for the time being, will the potential FSLIC loss get larger or smaller?

Q. 2) When should these insolvent institutions be closed?

Q. 3) How should the losses to FSLIC be covered?

RESPONSE TO SENATOR PROXMIRE'S QUESTIONS

FSLIC PROBLEMS

A. 1) FSLIC's losses in the long run will get smaller, I believe, because of recent Bank Board regulations limiting growth and direct investments. FSLIC's job is to mop up the old problems.

A. 2) Insolvent institutions should be closed as soon as possible within the limits of available resources. Various consignment management approachs should be used in the interim.

A. 3) Special assessments, income from the portfolio, stretching out FSLIC's problems, and the 406 Corporation are the ways to handle FSLIC's losses until FSLIC is over the hump.

This question raises a bigger issue: namely, who ultimately bears the responsibility for the problems that the savings and loan business finds itself in? Is it Congress or S & L management? The answer is "it depends." Certainly, where there are asset problems, it is management's fault, and management must bear the responsibility even if it is argued that deregulation forced management to seek higher yields and thus riskier transactions. On the other hand, if the problem is caused by spread, and if those spread problems are the result of the events of the 1979-1983 period (because institutions were so weakened and their net worth so erroded that they could never recover profitability), then Congress must bear the blame for the government's having locked the business into short borrowing and long lending through statute and regulation. But if spread problems occur in the future for companys that have made a profit in 1984 and 1985, then management must bear the full responsibility for failing to restructure during this window period of lower rates -- that is, for failing to give up some of their profitability to pay the price of restructuring.

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As you know, Congress passed the net worth certificate program In 1982. At the time, we thought these certificates would buy some time for troubled savings and loan associations so that they could re-structure their affairs. But according to a recent GAO report, those institutions getting net worth certificates have not used the time to get better. Instead, they have gotten worse. They have less capital today than 3 years ago.

I would like each of you to answer two questions:

Q. 1) Does it make sense to extend the program?

Q. 2) If Congress does extend it, what conditions should be attached to make sure it achieves its purpose?

NET WORTH CERTIFICATE PROGRAM

A. 1) Yes, the program should be extended. I have real questions about the GAO study. I have seen no real abuse of the program thus far, and in fact, some associations have begun to turn around as a result of the program.

A. 2) I believe the conditions in the current program are adequate.

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM

MR. RICHARD T. PRATT

Q. 1. What is your view of the National Council Task Force's proposal for risk-based net worth and a definitive time frame for an institution to come into compliance, or find a merger partner, or be placed into receivership?

A. 1. The idea of a risk based net worth requirement has many appealing aspects to it. To a substantial extent, risked based premiums and risk based net worth requirements are interchangeable. A risked based net worth is conceptually simpler and may provide more thoughtful analysis of risk bearing on the part of management. If a risked based net worth approach were instituted, I believe, the industry could come into compliance in a five year period. The regulators should insist on no new incremental risk bearing by non-complying institutions.

Q. 2. With regard to the proposed asset management subsidiary, is the real advantage the ability to manage problem assets outside the ceiling of federal pay caps? Isn't a disadvantage that the value of such assets would decline if they had to be disposed of on a stand alone basis - as opposed to being in a package of good assets and solid customers to be sold as a going concern? What are the pros and cons of one asset management subsidiary versus twelve?

A. 2. I do not see a real advantage of the asset management subsidiaries to avoid federal pay caps, rather, I see the asset management subsidiary as a vehicle which may allow tapping of the capital of the district federal home loan banks to further support the activities of FSLIC. This may or may not be appropriate in a public policy sense. I further believe, the asset management subsidiary may be a vehicle through which Congress could be drawn into subsidizing the disposition of problem institutions and problem assets.

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM

MR. RICHARD T. PRATT

Q. 3. If a substantial amount of the Home Loan Banks' assets consisted of loans to the FSLIC, could this severely lessen the willingness of the private sector to invest in a Home Loan Bank's debt instruments? Why or why not? Currently what is the total excess debt capacity of the regional Home Loan Banks?

A. 3. Should a substantial amount of the Home Loan Bank's assets consisted of loans to FSLIC, this could cause a reduction in the credit standing of the Federal home Loan Bank system. This could be overcome by a stronger guarantee of the U.S Treasury. The total excess debt capacity of the regional Federal Home Loan Banks depends upon the assumption as to the riskiness of loans made by those banks. If one believes that all risk is centered in FSLIC then the excess debt capacity of the regional banks is extremely large, in as much as no real capital is required to support their loans.

Q. 4. At what point would loans from the Home Loan Banks begin to impair the confidence of the private sector investors in the Home Loan Banks' debt obligations?

A. 4. Recent developments have caused at least temporary increases in the cost of agency securities as credit markets have called into question the ability of agencies to repay debt. A better issue for public policy is not how much should the Federal Home Loan Banks be involved in making loans to FSLIC, but what is the proper approach to the problems of the FSLIC, and what is the best public policy for dealing with these.

Q. 5. The primary supervision of thrifts has already been delegated to the local Federal Home Loan Banks. If the disposition of problem institutions were also delegated to the local banks, what would be left for the Bank Board? Wouldn't there be a danger of the Bank Board losing control?

A. 5. The Federal Home Loan Bank Board appears to be in a mode which will result in an eventual lessening of it's power and perhaps control over it's regional banks. Under certain circumstances it would certainly be possible for the bank board to have a diminished ability to control it's twelve district banks.

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM

MR. RICHARD T. PRATT

Q. 6. Should the FSLIC require its insureds to make a one percent deposit in the fund? Why or why not?

A. 6. The FSLIC should not require it's insurance to make a one percent deposit in the fund. If the savings and loan business is to remain a viable industry, and if as seems possible, the FSLIC may not have the financial resources to solve the problems, massive assessments on the part of the FSLIC will simply ensure that good associations as well as bad fail. It is asking the industries able to join hands with the unable, unwilling, and inept in a march to oblivion.

Q. 7. If the FSLIC and the FDIC funds are not merged, where will the FSLIC obtain sufficient funds to deal with its problems over time?

A. 7. It is a fact as to whether or not the FSLIC and the savings and loan industry have sufficient funds to solve thrift problems. In the event that they do not, and the FSLIC and FDIC are not merged, the two other sources of funds appear to be private sector and the federal government. Private sector funds can be tapped by enhancing the value of savings and loan charters to induce investors to buy those enhanced charters. As an option, the congress may deem it better public policy to use direct appropriations from the treasury to fund problems.

Q. 8. With regard to other forms of market discipline by uninsured depositors and general creditors, it is argued that the market discipline is fickle, is trendy. Indeed, it is argued that a run is the ultimate form of market discipline. How do you respond to these concerns?

A. 8. The private market may be fickle and market discipline may be fickle but it is likely not less fickle than government regulation. Even if market discipline is fickle and has weaknesses, the benefits to the consumers of deregulation far overshadow the cost of dealing with inadequacies in the private market.

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM

MR. RICHARD T. PRATT

Q. 9. Should the FSLIC be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed bank with any profit after administrative costs arising from the transaction returned to the original stockholders?

A. 9 I believe this would be poor public policy, stockholders should be viewed as the providers of risk capital and should be subject to the loss of their capital in the event that they are not able to manage their institution in such a manner as to avoid the necessity of the federal government paying their obligations.

Q. 10. If the burden of mismanagement was placed squarely and directly on the managers and stockholders, is it necessary to punish depositors and borrowers in order to achieve an improved supervisory system? If failures were handled through a purchase and assumption or forced merger at an earlier stage, regardless of size, wouldn't this dispose of the fairness question as it relates to large and small institutions?

A. 10. The question has an inherent conflict within it. If the burden of this management is placed on the managers and stockholders, it seems to me inconsistent at the same time, to expect the regulators to have such foreknowledge and precision in their judgement as to know when to step in and seize the association. Depositors and borrowers of various classes can be highly useful adjuncts to the federal regulatory system in requiring good management from institutions.

Q. 11. In your opinion, what are the advantages and disadvantages of risk-based capital and risk-based premiums? Should we consider one or the other or both?

A. 11. I believe that risk based capital and risk based premium seek to achieve the same ends. Risked based capital is an inherently easier scheme, one that requires investors to place capital at risk and requires them to be cognizant of the risk of loosing that capital, while risk based premiums in the absence of adequate capital standards may serve little useful purpose. Substantial capital requirements combined with risk based premiums could be as effective as a risked based capital approach.

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM

MR. RICHARD T. PRATT

Q. 12. There appears to be strong support for risk-based capital in some form. Some suggest an adoption of risk-based capital by the federal insurance agencies would give them the necessary authorities to regulate the activities of state-chartered institutions without granting the authority to override a state legislature. What is your view?

A. 12. The Federal Government should not be so squeamish in it's insistence upon the need to regulate federally insured institutions, whether federal or state chartered. The entire raison de'tre of insured financial intermediaries is based on the provision of federal insurance it is totally inconsistent to allow states to make rules which affect the cost of risk bearing by the federal insurance corporations.

Q. 13. How would you recommend resolving the dilemma to the dual banking system created by states authorizing activities which place the federal insurance agencies at risk?

A. 13. Rules and regulations which are associated with risk bearing on the part of insured institutions should be promulgated as insurance regulations and be equally applicable to state and federally chartered institutions.

Q. 14. Do you believe that the FHLBB and/or FSLIC needs increased enforcement authority? If so, in what areas?

A. 14. I generally believe that the Federal Home Loan Bank Board and FSLIC have adequate enforcement authority.

Q. 15. Does the Community Savings and Loan and EPIC problem reinforce the need for certain activities to be engaged through a subsidiary of the holding company rather than a subsidiary of a depository institution?

A. 15. Not necessarily, however, the requirement that certain activities be engaged in through subsidiaries of the holding company may be more effective than other approaches to controlling the risk of such subsidiaries.

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM

MR. RICHARD T. PRATT

Q. 16. How can or should we determine if the size of the insurance fund is sufficient and will continue to be sufficient to assure confidence and manage the costs of potential failures?

A. 16. There are several approaches which may shed some light on the adequacy of the federal insurance funds. One of these might involve a national study which essentially marks to market the assets and liabilities of troubled institutions determines the implicit loss and compares this to the present value of expected collections of insurance premiums. The second approach would simply be through a cash budget extension involving the best estimates of future expenditures required by the FSLIC and expected revenues.

Q. 17. In your testimony you stated that the regulators should "cause financial institutions to allocate resources and make decisions as if federal deposit insurance did not exist." I agree with that but you go on to say "There is a substantial question as to whether or not regulators have sufficient incentive to make the difficult decisions necessary..." Can you explain that statement more fully?

A. 17. Federal regulators may not always perceive that they are rewarded by implementing good public policy or they may not have the abilities to evaluate the public policy implications of their actions. Close relationships between federal regulators and the industry and more especially between federal regulators and the major trade associations may lead to decisions which may appear popular or expedient in the short run, but harm the industry as well as the public over the longer period.

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM

MR. RICHARD T. PRATT

Q. 18. As to current value accounting, if we moved toward current value accounting for regulatory purposes only - wouldn't this:

a. Give managers better data from which to make decisions?

b. Provide regulators and insurers with a clearer picture of an institution's risk?

and c. Minimize the industry resistance since such reports would be confidential at least during a transitional phase?

A. 18. The single best reform which could occur in regulation for thrift institutions may be the requirement of mark to market accounting. It would:

a. Give managers better data from which to make decisions.

b. Provide regulators, insurers with a clearer picture of an institutions risk.

Under the present approach to providing deposit insurance, retaining the confidentiality of mark to market information would seem to do little harm. However, in general, the public would be better served, certainly public investors, in the securities of financial institutions would be better served by mark to market accounting information.

Q. 19. With regard to your risk sharing or deductible insurance plan, would this increase the costs of managing a failure for the insurance agencies?

A. 19 NO.

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM

MR. RICHARD T. PRATT

Q. 20. You suggest "opening up the acquisition of financial institutions to well-capitalized responsible acquirers". How would you determine which potential acquirers are sufficiently "responsible"? Do you have concerns over breaking down the remaining barriers between banking and commerce? Are there many potential acquirers? Who? What would be the potential advantages to the acquirers?

A. 20. The responsibility of potential acquirers of financial institutions should be based to a substantial extent on their ability and willingness to provide real risk capital. I do not have concerns for the breaking down of the remaining barriers between banking and commerce, except that the government should be highly aware of the trend toward the implicit government guarantee of equity and debt instruments of corporations through laundering these obligations through financial institution deposits. The main requirement is reformation of the federal deposit insurance agencies. I believe there are numerous potential acquirers of financial institutions, whether there are enough to solve all the problems within the financial intermediary industry is unknown. Other firms and various dimensions of the finance industry would certainly be appropriate acquirers as would major industrial corporations having substantial finance or finance related businesses.

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM

MR. RICHARD T. PRATT

Q. According to the Bank Board, there are over 400 savings and loan associations that are insolvent under generally accepted accounting principles. These associations have combined assets of over $100 billion. It has been estimated that the loss to FSLIC would be at least $15 billion if these associations are liquidated. I would like each member of the panel to answer three questions:

1) If nothing is done for the time being, will the potential FSLIC loss get larger or smaller?

2) When should these insolvent institutions be closed?

3) How should the losses to FSLIC be covered?

A. 1. If nothing is done the losses at troubled Savings and loan associations will increase.

2. Insolvent and non-rehabitable institutions should be closed as early as possible.

3. Losses to the FSLIC should be covered using the following sources of funds:

1. Private capital from acquirers who are willing to assume some losses in return for the privileges granted through the receipt of a insured financial institution charter.

2. Reasonable assessments against the savings and loan industry commensurate with the ability of healthy institutions to contribute to the insurance fund without threat to their basic viability and consistent with equity in assessments between the various federal insurance agencies.

3. Direct federal expenditures.

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM

MR. RICHARD T. PRATT

Q. As you know, Congress passed the net worth certificate program in 1982. At the time, we thought these certificates would buy some time for troubled savings and loan associations so that they could re-structure their affairs. But according to a recent GAO report, those institutions getting net worth certificates have not used the time to get better. Instead, they have gotten worse. They have less capital today than 3 years ago.

I would like each of you to answer two questions:

1) Does it make sense to extend the program?

2) If Congress does extend it, what conditions should be attached to make sure it achieves its purpose?

A. 2. Regarding the net worth certificate program:

1. It makes sense to extend the net worth certificate program on a limited basis to:

1. Facilitate an orderly dealing with problem institutions.

2. To provide an alternative to the direct expenditure of treasury funds in order to facilitate the political sensitivities of congress. It is probably not economically feasible to maintain a substantial net worth certificate program, but it may be politically attractive to do so. It is likely that institutions which are not viable under the present market and interest rate scenario will never be viable and it becomes a political question as to when the real cost of these failures are recognized and dealt with by congress.

2. If congress does extend the net worth certificate program it should be to serve the purposes of congress and not to facilitate the continued operation of institutions which are incapable of being viable on a independent basis. The Regulator should not be allowed to use the net worth certificate program to carry favor with the industry or it's trade associations.

3. For the most part the net worth certificate program should be viewed as a device for modifying the payment of federal monies to deal with troubled thrift institutions and not as a general method of saving or extending the life of failed institutions.

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The CHAIRMAN. Next I'd like to call to the witness table Mr. Brent Beesley, Andrew Carron, and Arthur Warner.

Gentlemen, we are happy to welcome all three of you here today and, first, Mr. Beesley, another present Utah constituent of mine who is operating down in Utah's Dixie right now where it's very hot, though not humid like we have here. Please proceed.

STATEMENT OF H. BRENT BEESLEY, FORMER DIRECTOR, FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION; CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, FIRST CHARTER SAVINGS BANK, ST. GEORGE, UT

Mr. BEESLEY. Mr. Chairman, I appreciate this opportunity to testify before your committee.

As you are an expert Air Force pilot, I'd like to invite you to imagine yourself at the controls of a powerful airplane racing down a runway. As your plane lifts off and begins to climb out into the clouds, you discover that your instruments remain fixed on their pretakeoff settings.

The CHAIRMAN. You're getting me so excited I want to leave.

Mr. BEESLEY. Your frustration and anxiety at that point would be similar to the frustration and anxiety that I felt as Director of the FSLIC when I tried to assess the condition of various S&L's using GAAP and RAP financial reports.

IRRELEVANCE OF PRESENT ACCOUNTING PRACTICES

Both generally accepted accounting principles [GAAP] and regulatory accounting principles [RAP] are based on irrelevant historical factors, pretakeoff settings if you will, and not on present realities. It is interesting to note that historical cost accounting was adopted for financial institutions during the Great Depression to camouflage the wholesale failure of the life insurance industry and this accounting system has been concealing reality ever since.

It would seem obvious that when a S&L's reported net worth reached zero that its assets should at least approximate its liabilities. If I learned anything as the Director of the FSLIC, it was that there is little correlation between reported net worth using audited GAAP or RAP statements and the actual losses the FSLIC was suffered in resolving problem cases.

The GAO has recently given the FSLIC a qualified opinion because the FSLIC is unable to determine its exposure to loss on cases already handled. The GAO has also correctly opined that it is impossible for the FSLIC to predict its future exposure to loss.

Perhaps even more distressing is that S&L executives are compelled to take actions to improve GAAP or RAP net worth or earnings which actions can and actually do reduce the economic value of the institution and increase the exposure of loss to the FSLIC.

Mr. Chairman, Congress has the ultimate responsibility to set accounting standards in the United States. In a manner similar to the mandate of section 712 of Garn-St Germain, I urge the Congress to require the financial services industry, its regulators, the SEC, and the accounting profession, to submit to Congress a framework for a new financial accounting system.

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This system should not be based on historical cost data, but should be reflective of economic realities in the business environment. It should reveal the strengths and weaknesses of institutions, their exposure to credit risk, and interest-rate risk. This would reduce to some degree the pressure on examiners to determine the level of these types of risks.

The new system should clearly indicate the amount of real economic capital that stands between the risks carried by an institution and the Federal deposit insurance agency involved.

All this discussion about capital and risk-related premiums is moot unless we have some measure to determine what the capital in a financial institution is.

Had such an accounting and reporting system been in existence for the last 20 years, it would have saved billions of dollars in losses to the FSLIC and to the S&L industry. This new system would provide data to properly manage S&L's and would provide the basis for a rational regulatory scheme.

During the early 1980's any suggestion of imposing a realistic accounting system on the industry was met with protests that results would reveal that nearly all the thrift industry had a negative net worth. Fortunately, that excuse is far less relevant today. However, the adoption of an accurate accounting system would require managers to reduce their exposure to risk, be prepared to absorb risk through increased real capital, or they would be forced to report negative net worth as conditions changed.

If regulatory action is taken when real net worth reaches zero, there should be no loss to the FDIC or the FSLIC and, therefore, no need for premiums or large insurance reserves. In fact, the accuracy of the new accounting system could be measured by the extent of the loss incurred if an institution is liquidated when reported net worth equals zero.

PLANS TO REDUCE THE COST OF LIQUIDATION

As you know, the FSLIC may not elect any solution for problem cases which exceeds the cost of liquidation. For this comparative purpose the FSLIC should be using the least costly method of liquidation. In my written testimony I've described one example of a plan to reduce the cost of liquidation which has not been used. Mr. Janis has suggested another method to reduce costs.

Implementing these plans and/or developing other useful tools will require management skills and creativity which are, unfortunately, also in great demand in the private sector. As the S&L industry is funding the FSLIC, the industry ought to be able to pay for the talent required to get the job done most cost effectively. I urge Congress to support the request made by Chairman Gray to move the nonadministrative FSLIC functions from under the Federal restraints on hiring and salaries.

The comments of Senator Proxmire notwithstanding, from the evidence available to the public, I see no justification for any plan to infuse large sums of money into the FSLIC at this time. Assuming the human resources can be marshalled, I agree with Chairman Gray that the FSLIC should be able to manage its current

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case load on an income stream which approximates $200 million a month.

Protection of the Federal deposit insurance funds and/or the notion of financing home ownership should not be used as a basis to limit the reasonable prerogatives of management or restrict the ability of institutions to be competitive. We must not forget that the majority of S&L's that went out of business during the early 1980's failed because they were engaged in home mortgage lending as required by law. History has proven time and again that Government is not very good at determining what types of risks management ought to take. Of course, every regulator believes he is the exception to this rule.

My association in Utah is a classic case of an S&L that had gone broke making residential mortgages. Today, thanks to new capital, prudent use of brokered deposits, and State granted powers, this institution is profitable, has real net worth, and virtually no exposure to interest rate or credit risks. While this institution poses no risk to the FSLIC, the greatest risk it faces is that the FSLIC will promulgate restrictive regulations. Congress should not allow regulators to repeat the past mistakes of overregulation.

The better way to protect the integrity of the Federal deposit insurance system is to: One, implement an accounting system which accurately discloses the condition of institutions; two, require that institutions maintain real capital; three, provide a regulatory climate that fosters diversification; and four, allow management the maximum flexibility to respond to changes in the business environment.

This approach, coupled with good supervision and examination, will attract new capital and talented managers to the industry. In the long run, it will result in less loss to the insurance funds.

Mr. Chairman, I'm optimistic that the financial services industry and particularly the S&L industry will evolve through the current period of adjustment without major disruption to the public and without taxpayer funds being expended to protect depositors.

Again, I appreciate the invitation to testify and, more, I appreciate your support over the last several years. Thank you.

[The complete prepared statement follows:]

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FEDERAL DEPOSIT INSURANCE

and the

REGULATION OF FINANCIAL INSTITUTIONS

Testimony of H. Brent Beesley

before the

UNITED STATES SENATE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

JAKE GARN, CHAIRMAN

July 25, 1985

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Mr. Chairman and distinguished members of the Committee, I appreciate this opportunity to testify on matters that have concerned me for the last four years. During my tenure at the FSLIC, I experienced firsthand some of the greatest challenges that have yet been hurled at the deposit insurance system. Indeed, 95% of all the problem assets handled by the FSLIC from the Great Depression through the spring of 1983 were handled during the two years of the Pratt Administration at the Bank Board. The case load of failures resolved by the FSLIC from 1981 through 1983 was over fifty times the historical average level. Almost one-fourth of the S&L industry, or about 1,000 institutions, disappeared during this short period. It is remarkable that there was so little disruption to the public as a result of that tremendous consolidation.

Since leaving the FSLIC, I have been involved with a small S&L in St. George, Utah. This experience has brought the issues further into focus as the fortunes of my institution are inextricably connected with the well-being of the FSLIC, the regulations promulgated by the FHLBB, and the laws enacted by Congress.

I have followed with great interest the recent swirl of discussions and the flurry of studies on the topic of deposit insurance and regulatory reform. Recommendations for Change in the Federal Deposit Insurance System, produced by the Cabinet Council on Economic Affairs Working Group on Financial Institutions Reform, is a thoughtful and important contribution. Agenda for Reform and Deposit Insurance in the Changing Environment,

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prepared pursuant to Section 712 of the Garn-St Germain Depository Institutions Act of 1982 add significant background and several useful recommendations.

On this occasion, I desire to direct my comments as a private citizen to those issues which have either been overlooked in the current studies and debates or on which my views are somewhat at variance with most of the other commentators. Given my background and experience, the majority of my testimony will pertain to the FHLBB, the FSLIC and the thrift industry. **(Specific recommendations to Congress and/or the regulators are written in this darker print.)**

ASSESSING AN INSTITUTION'S CONDITION

Perhaps the most serious shortcoming of the existing system of savings and loan regulation in the United States is the inability and/or unwillingness of the Congress and the regulators to develop and require an accurate and meaningful accounting and reporting system for this trillion dollar industry. The Securities and Exchange Commission, the federal agency charged with accounting standards, and the accounting profession itself must also bear significant blame for their lack of initiative in this regard.

Much has been said about moving from Regulatory Accounting Principles (RAP) to Generally Accepted Accounting Principles (GAAP), but this discussion misses the entire point. The present system of financial reporting under GAAP was devised during the Great Depression to

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camouflage and conceal the wholesale failure of the insurance industry. Unfortunately, the system has performed only too well in that GAAP to this day is effectively camouflaging and concealing the actual condition of S&L's. The three major risks faced by most financial intermediaries are virtually ignored by both GAAP and RAP. The extent of an institution's exposure to credit risk, interest rate risk and liquidity risk cannot be accurately determined from statements based on historical costs.

GAAP and RAP reports are as useless to thrift regulators and managers as broken altimeters and caged gyroscopes are to pilots. Just as the broken instruments fail to reveal changes in an aircraft's position relative to the ground, GAAP and RAP both ignore important changes in the environment which materially impact an institution's ability to compete and survive.

There is no need to recite horror stories here; suffice it to say that all too often management decisions have been and are being made to improve GAAP or RAP reports, which decisions have reduced and do reduce today the economic value of the institution and increase the potential loss to the deposit insurance agencies.

It would seem obvious that if an S&L or savings bank has a net worth of zero, that its assets would equal its liabilities. As a new director of the FSLIC, I was quickly taught by experience that reported net worth, using either GAAP or RAP, had little correlation to the actual losses the FSLIC faced in resolving a situation. Using the enormous data base that the FHLBB had collected

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at great expense over the previous several years, I attempted to determine the expected date of failure and the anticipated cost of resolving any given problem institution from the data on hand. It was not possible!

Despite the millions of dollars that are paid annually for audited financial statements by S&L's and the millions of dollars that are spent in providing reports to the FHLBB, nowhere could anyone produce the basic information required to accurately assess the real costs facing the FSLIC. It is also clear that most managers were not looking at information that was essential in assessing the true financial condition of their respective associations.

The FHLBB has recently taken several commendable steps toward the goal of reasonable financial reporting for the S&L industry. Specifically, the new Schedule K of the Quarterly Report now requires some information regarding the final maturity or repricing period of assets and liabilities. (Prepayment and amortization information is ignored.) There is also a new regulation that requires management to report periodically to their boards of directors on the ramifications to their respective institutions resulting from changes in the interest rate environment.

The national debate over GAAP vs. RAP should be brought to an end by recognizing that both systems are based on historical costs and are therefore of little value in the current environment. It should also be recognized that carrying "goodwill" on the balance sheet is no different than carrying underwater assets at historical cost.

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Until a new financial accounting system has been developed and tested, all financial institutions insured by the FSLIC should include in their existing GAAP or RAP reports to the regulators supplemental schedules of the market value of the institution's assets and liabilities, the anticipated cash flows from its assets and liabilities, rate and maturity information on its assets and liabilities, and detail on substandard assets. The preparation of these reports is not onerous with the help of a computer. This information is something that management should already be developing and utilizing. Please note that securities dealers re-evaluate their assets monthly for regulatory purposes. This procedure provides marvelous discipline.

During the course of examinations, regulators should review the reasonableness of the assumptions used in these reports. Examiners should exercise the authority to "write down" assets as necessary.

An accurate and meaningful accounting system should be imposed on the financial services industry. In a manner similar to the mandate of Section 712 of Garn-St Germain, Congress should require the financial services industry, its regulators, the SEC and the accounting profession to submit to Congress a framework for a new financial accounting system. This new system should not be based solely on historical cost data but rather be reflective of the economic realities in the current business environment. The new system should reveal the strengths and weaknesses of the institution and its exposure to credit risk, interest rate risk, liquidity

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risk and other potential risks as well. The new system should clearly indicate the level of real economic capital that stands between the risks carried by an institution and the federal deposit insurance agency involved. This new system should facilitate the public's ability to compare the financial strength of one institution with another.

Had such a system been in existence for the last twenty years, it would have saved billions of dollars in losses to the FSLIC and the S&L industry. This new system would provide the data to properly manage S&L associations in the present and would provide the basis for a rational regulatory scheme in the future.

During the early 1980's any suggestion of imposing a realistic accounting system on the S&L industry was met with a chorus of howls and protests from executives and trade associations that the results would reveal that nearly every thrift had a negative net worth. Fortunately, that excuse is less relevant today. The average yield on the portfolio of the nation's thrifts is very near the market rate for new investments of comparable quality and term. However, adoption of an accurate accounting system would require managers to reduce risk, be prepared to absorb risk through increased real capital or report a negative net worth.

CAPITAL ADEQUACY

There has been much discussion regarding risks imposed on the FSLIC from direct investments, powers

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granted by the various states, brokered funds, etc. These issues become moot if a system can be developed to assess the risks involved and adequate real capital is required. Making loans and investments in a wide variety of enterprises is a proper role for financial intermediaries and provides for diversification. Such loans and investments are an integral part of our dynamic national economy and should be encouraged if the associated risk is properly covered.

The FHLBB has recently taken steps to tie certain activities such as new growth, brokered deposits and direct investments to capital adequacy. **Although the FHLBB is using a capital figure that is calculated according to GAAP or RAP and therefore largely irrelevant, the concept of tieing capital to risk taking is very important precedent. This process should continue.**

In order to attract new capital to the financial services industry, it is imperative that there be an opportunity to make a reasonable return on that investment. There was a marked increase in new capital investment in the S&L industry following the passage of Garn-St Germain. It appeared that management and capital were emerging as the dominant factors in the equation for success. As regulatory factors have to some degree reasserted dominance under the banner of protecting the insurance funds, new capital formation is decreasing.

Regulators should create a climate that allows financial institutions to engage in a wide range of reasonable risk taking. Adequate real capital should provide the protection for the insurance funds rather than

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outright prohibitions or limitations on activities. This approach will attract new capital to institutions, stimulate the economy and protect the federal deposit insurance funds.

There seems to be little justification for S&L's having a lower capital requirement than commercial banks. This is particularly true if S&L's elect to continue the enormous exposure to interest rate risk they currently maintain. **The capital requirements for S&L's should be increased over time, but again, this is a moot issue until real capital can be effectively measured.**

SIZE AND MANAGEMENT OF THE FUNDS

The size of the FSLIC, FDIC and NCUA funds is not the real issue. There is a contract between the people of the United States and their Government. Insured depositors expect to be protected regardless of the reserves of the insuring agencies. The real issue is how much money is it going to cost to solve the problem cases, who is going to pick up the tab and when.

It should be recognized and understood that the cost of resolving the problems facing the FSLIC is to a great extent a function of how the FSLIC is managed. This conclusion is supported by the October 14, 1983, report to Congress by the Comptroller General, The FSLIC Insurance Fund--Recent Management and Outlook for the Future. (GAO/GGD-84-3)

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While quality of management will make a significant difference in the FSLIC's cost of resolving problems, unfortunately the skills required to manage the challenges facing the FSLIC are the same skills that are currently in great demand in the private sector. Experts in mergers and acquisitions, mortgage-backed securities and distressed real properties, for example, are often able to command monthly salaries in excess of the top annual salary at the FSLIC. During the early 1980's, the FSLIC put together more mergers and acquisitions than most of the leading New York investment banking houses during the same period, measured either in total assets or in total numbers. It is not surprising that virtually all the senior professional staff involved in the FSLIC's merger activity has now moved on to higher paying jobs or more promising opportunities.

With the help of a few optimistic assumptions, I am of the opinion that the S&L industry will be able to pick up the tab at the FSLIC without having to rely on other federal agencies or the taxpayer. If this is true, the industry is entitled to pay for the talent it deems necessary to deal with the FSLIC's problems. The FSLIC has lost many millions of dollars due to a lack of adequate staff and talent. This was true while I was there, and it is true today. The present budgetary restraints on the FSLIC are a classic case of "penny wise and pound foolish." Those that are paying the premiums are willing to pay whatever it takes to attract and keep the best talent available. **The FHLBB's proposed legislation to remove the FSLIC from federal restrictions on hiring and salaries should be enacted.**

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The decision of the FHLBB to increase the FSLIC premium was well founded and totally appropriate. It is likely that these higher premiums will be necessary for several years. **Efforts to find a painless way to finance the FSLIC through accounting gimmickry should cease, and those energies should be applied toward improving the FSLIC's ability to deal with its case load.**

If the agency needs more money, then additional contributions to the FSLIC should be made by the S&L industry and properly expensed. These contributions should not be carried as an asset on the industry's books. If the FSLIC needs the money to resolve cases, then there is no basis for S&L's capitalizing the contribution; if the FSLIC does not need the money to resolve cases, then there is no basis for S&L's paying the contribution.

There is no evidence in the public domain that the FSLIC should be given large sums of new money from any source at this time. "Necessity is the mother of invention," and there is much that can yet be done with the FSLIC's current resources and the additional premium income it now has.

In case the need should ever arise, Congress should give the FDIC the legal authority to increase its premiums.

EXAMINATION AND SUPERVISION

Improving the examination and supervisory process is

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an ongoing challenge, but there has been much progress made in this area during the Gray Administration at the FHLBB. The recent transfer of the examination staff to the district banks should provide ample resources for this important task. Further, there is encouraging progress in the FHLBB's ability to identify potential problems through computerized analysis of the various reports filed by the individual associations. **The recent changes in the examination and supervision areas need time before their effectiveness can be evaluated.** I anticipate the results will be encouraging. **Due to the complexity of many of the problems facing the examiners today, the use of experts in the examination process should be more widely used.**

REDUCING THE COST OF PROBLEM SOLVING

The cost of resolving problem cases was reduced dramatically during the Pratt Administration at the FHLBB. A primary factor in this success was the ability to generate alternatives. "One's negotiating position is only as good as one's next best alternative." **The FSLIC must continue to generate new and more effective methods to resolve problem cases.**

While every option adds to the FSLIC arsenal, the currently-heralded program to have strong institutions lend their management to failed institutions is fraught with problems. This plan was developed and used several times during the early 1980's. However, it has value only as a holding or warehousing device. **It should be remem-**

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bered that in the presence of strong and well-capitalized competition, there is generally only one way for an association to get off the FSLIC problem list.

It is almost impossible to convince an American manager that his job is to minimize the eventual cost to the FSLIC if that course involves shrinking and liquidating an institution. Everyone wants to be a hero and make a profit. Those desires eventually lead to trying to turn the failed institution around. There is also a mentality at the FHLBB, certainly at the United States League of Insured Savings Institutions and perhaps even here in the Congress that failed institutions should not be quickly removed from the marketplace. This view has cost the FSLIC many millions of dollars, and it serves little useful purpose.

The only justifiable reason to maintain a failed institution in the marketplace is if the cost of funds in that institution, adjusted for overhead expense, is less than the cost of funds or the opportunity cost available to the FSLIC or the FDIC. This situation existed during the early 1980's. At the Economy Savings and Loan liquidation in Chicago in May 1981, which was the first FSLIC payout in ten years and among the largest to that date for either a bank or an S&L, the FSLIC paid out about one hundred million dollars for deposits earning less than 10% with money that cost the FSLIC about 15%. When several New York S&L's failed a few months later, the first Pheonix was born to take advantage of these institution's lower cost of funds.

Today, however, the cost of funds in most failed

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institutions is in excess of the FSLIC's cost of funds or investment alternatives. Therefore, leaving these institutions in business increases the loss to the insurance funds, regardless of how pristine their new management may be.

Congress has mandated that the FSLIC may not elect any solution to resolve a problem case if the cost of the proposed solution is in excess of the cost of liquidation except in very special circumstances. The spirit of this statute is ignored if the FSLIC is not constantly working to develop tools to reduce the cost of liquidation.

The measure that has been consistently used by the FSLIC to calculate the cost of liquidation for these comparative purposes has been the estimated market value of the failed firm's assets minus its total liabilities. There are less costly approaches to liquidating an institution.

The following is an example of just one approach which has not yet been used that would significantly lower the cost of liquidation. **The FSLIC should establish a subsidiary which we will call "FSLIC Financing Subsidiary."** The purpose of this subsidiary would be to acquire the mortgage-related assets of failed institutions when and if less-costly alternatives are not available. The FSLIC Financing Subsidiary would have several ongoing options for assets transferred to it. One option would be to keep the assets in portfolio and to finance the portfolio with collateralized mortgage obligations (CMO's) issued by the investment banking community. These CMO'S could also have certain FSLIC guarantees as required to

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decrease their effective cost. The cost of these funds would be lower than the cost of comparable funds in the failed firm and overhead would be much reduced. Financing the assets in the manner suggested would also remove the FSLIC from further exposure to interest rate risk from these assets, which it would not have done if the assets had remained in the failed institution. A second alternative is to package and sell the mortgages outright with FSLIC guarantees, as appropriate, or perhaps with FHLMC guarantees issued for a fee.

The non-mortgage assets of the failed firm could also be held until resale in another FSLIC subsidiary which might be named "FSLIC Asset Management Corporation." This corporation could be very useful in dealing with the credit problems that seem to be plaguing the FSLIC of late. These assets could be financed through Federal Home Loan Bank advances, bond issues and other borrowings at less expense than maintaining the overhead and cost of funds of the failed firm. This warehousing tool also reduces the need for a large FSLIC fund and allows the FSLIC to pay the loss on the eventual disposition of these problem assets over a longer period of time.

Having stripped the assets from the failed firm and placed them in the two subsidiary corporations as suggested above, the FSLIC can now seek to sell the deposits and physical facilities of the failed firm to bidders. This clean balance sheet approach lends itself to a quick response from bidders and to a quick resolution of the problem. Such an approach eliminates the very difficult and time consuming efforts on behalf of bidders to assess the value of the failed firm's assets. In many cases,

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those desiring to acquire the deposits are not interested in acquiring assets. Bidders will generally pay a premium for retail deposits in the range of 3% to 10% of deposit balances assumed and more if new territorial rights are part of the package. If no acceptable party can be found to assume the liabilities, the deposits can be paid pursuant to the convenient and non-disruptive methods for payoffs that have been developed.

Under present conditions, the above approach would result in a major decrease in the cost of liquidation. In fact, in many of the so-called "spread type" cases, the cost of liquidation would approach zero. **If the FSLIC has other options for the resolution of its problems cases, which fortunately it does, the cost of such options should not exceed the least costly method of liquidating the failed firm. Therefore, as the cost of liquidation falls, there will be established an ever lower maximum cost for resolving problem cases.**

Some argue that the transfer of deposits or the actual closure of offices is not healthy for the industry or the public. It is increasingly difficult to base any argument to maintain a failed firm in the marketplace on the notion of providing financial services to the public. Today the public is barraged with purveyors of financial services. Competition for the saver's funds and for the borrower's loans is awesome. The electronic revolution has put financial institutions from virtually every corner of the nation in touch with customers and potential customers everywhere, including St George, Utah. **No longer should Congress or the FHLBB be sidetracked by the old arguments that any particular industry or firm is**

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essential. If there is a profitable way to serve the community, the community will be served without preserving a failed institution. **The role of Congress and the regulators should be to provide a climate where competition and creativity can flourish; their only worry about those who can't make it should be the methods and costs of removal.**

CAPITAL ASSISTANCE PROGRAM

I am privy to no evidence that the Capital Assistance Program has resolved problems cases in any meaningful way. Interest rates have fallen since the program was implemented which may result in reducing the ultimate cost of resolving these cases. The program has also bought time for regulators to deal with the more pressing problems while these cases simmered. Whether or not the Capital Assistance Program is continued should hinge on the capacity of the FDIC and the FSLIC to find real solutions for these cases at this time. There is no economic theory that would support the notion that institutions requiring capital assistance can compete against well-capitalized firms in this environment. A firm on capital assistance generally has only one strategy for survival; it must take abnormal risks and hope for above normal returns. As an FSLIC premium-payer, I am not comfortable playing the odds that a weak S&L is going to consistently beat the market. **The Capital Assistance Program should be terminated as soon as it is feasible for the regulators to successfully resolve these cases.**

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TIMING OF MERGERS OR CLOSURE

If the FSLIC and the FDIC had accurate systems to measure the true net worth of their respective member institutions and if these agencies took action at the time real net worth reached zero, there would be no need for large insurance funds or for future premiums. The only costs would be the administrative costs of the agencies which could be covered by very small assessments.

Since there is not an accurate system in place to measure real net worth, any reference to net worth levels as a trigger to taking action is arbitrary. The FSLIC has generally waited until GAAP or RAP net worth was zero before taking action. This has been particularly true in the case of the large publicly-held institutions. However, in some of these cases, real net worth was more than a half a billion dollars in the red by the time GAAP net worth finally reached zero and appropriate FSLIC action was taken.

Unfortunately, during the crisis of the early 1980's and to some extent today, the real trigger for FSLIC action was the availability of human resources. The monthly numbers of mergers and liquidations so diligently reported by the media were more a function of organizational efficiency and available personnel within the FSLIC rather than a function of economic factors affecting the S&L industry.

Eventually, the FDIC and the FSLIC should close institutions before real net worth reaches zero. Before this policy can be implemented, there must be a system

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developed to measure real net worth and there must be time for institutions and regulators to adjust to the discipline of the new system. **For the present, problem institutions should be addressed when GAAP or RAP net worth falls below some arbitrary but increasing minimum level unless evidence can be produced that the institution has real net worth based on anticipated cash flows, unrecognized gains in the assets or other factors not considered by GAAP or RAP.**

The recent special premium assessments by the FSLIC have had a very beneficial effect on the willingness of the industry to allow the FSLIC to take prompt action in removing failed firms from the marketplace. Today the FSLIC is actually being urged by many to move more aggressively on failed institutions. Widespread support for decisive action was not forthcoming during the crisis period 1981-1983. Diligent efforts to resolve problems cases in a timely manner even resulted in accusations from the floor of the House of Representatives that I considered S&L's to be mere "building blocks in the playpen of the FSLIC."

RISK-BASED PREMIUMS

The concept of a risk-based premium makes sense and should be implemented but for different reasons than those currently being propounded. The flat premium structure is simply not fair. No risk-based premium structure will be perfectly equitable, but a simple sliding premium based on real economic capital at risk or such other factors will be more fair than what we now have. A variable-rate

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premium can also be used to give emphasis to certain regulatory priorities.

We should not expect too much from risk-related insurance premiums; they are not a panacea. A variable-rate premium will not significantly alter a risk-taker's strategy unless the incremental premium is very large indeed. No level of premiums would deter the firm that had no chance of survival without taking extraordinary risks.

PERIOD FOR ADJUSTMENT

It is important that public policy recognize that both banks and S&L's are going through a difficult period of enormous change. This is due to a veritable technological revolution, deregulation, tremendous new competitive pressures and other factors. During this transitional period, Congress and the regulators should try to provide stability where possible while allowing the evolutionary process to continue. This policy will result in some short-term policy inconsistencies as discussed below.

DISCLOSURE OF REGULATORY ACTIONS

The goal of total disclosure of all relevant information possessed by regulators is laudable. Now is not the time, however, to disclose routine enforcement actions. Not only could this disclosure be destabilizing, but such disclosure would also have a chilling effect on these actions being brought in the first place.

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Unless Congress is willing to eliminate federal deposit insurance and federal bank regulation in favor of a market-based system, a proposition worth consideration in a future period, there is little to be gained by airing the dirty laundry of a particular institution. Such information is irrelevant to the insured depositor. If it becomes relevant, then there is so much additional information that would be needed to form a meaningful assessment of a bank or S&L that it would inundate the consumer. This would result in a new industry to digest and disseminate the information together with the additional cost associated therewith.

CIVIL AND CRIMINAL PENALTIES

Rather than concern depositors with information on routine enforcement actions, the regulators should assess monetary penalties against institutions that violate regulations. Regulators should also vigorously pursue managers and directors that have taken their institutions beyond the realms of prudence and reasonableness. Disclosure at this point is appropriate, and both civil and criminal charges should be pressed. There should be an investigation made in every case requiring the expenditure of federal deposit insurance funds.

REDUCED COVERAGE AND PRIVATE DEPOSIT INSURANCE

At this time, private deposit insurance would not work without a federal reinsurance program. The power to

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close an institution, which is vital to contain the costs of insurance, should remain with the government for the present. Therefore, even if we had private deposit insurance, the federal deposit insurance agencies would need to remain with their associated regulations and overhead. Recent events have shown that private deposit insurance would be less stabilizing than the federal system and would therefore be inappropriate during the present period of adjustment. Private insurance would add yet another expensive layer of overhead to the supervisory process, the cost of which would ultimately be born by the consumer. Therefore, private deposit insurance as a substitute for federal insurance should be deferred to the future.

Restrictions against private insurance as supplemental insurance for large deposits should be removed. The use of private insurance in this limited way would provide valuable information and experience for both the regulators and the industry.

For fear of creating undue instability during this period of adjustment, there should be no change in the coverage of federal deposit insurance for the present time. The existing system is admittedly inconsistent with the basic principles of a free market economy. Eventually it may be appropriate to "let the saver beware" and to remove virtually all restrictions from depositories except those required to protect the payment system, assure disclosure and prevent fraud.

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UNINSURED DEPOSITORS AND "TOO BIG TO FAIL"

The necessity for stability notwithstanding, the doctrines of "too big to fail" and "all depositors in big institutions are insured" should be repudiated. New methods for dealing with large failures should be developed. The FDIC's "modified payout plan" and the "receiver's certificate concept" are examples of what can be done. **Uninsured depositors should be exposed to risk of loss in the event of failure. Most importantly, there should never be value left on the table for stockholders or unsecured bondholders of an institution where federal insurance funds have been deployed at a loss. These principles should be applied consistently to both large and small institutions.**

MERGER OF FSLIC AND FDIC

The FSLIC and the FDIC should not be merged. This recommendation is not based on the notion that either thrifts or banks are special or that such a merger of the funds would somehow reduce the availability of mortgage money. **The agencies should remain separate to stimulate regulatory competition and to diffuse power.** It is notable that even as the FHLBB is limiting direct investments for thrifts, the FDIC is considering expansion of these powers. Often the FHLBB has broken the new ground in expanding managerial prerogatives.

Another reason to maintain the separate funds is that the challenges facing both these agencies will be very great for the next several years. There are enough

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substandard farm, foreign, energy, shipping and commercial real estate loans buried in the portfolios of the nation's commercial banks to keep the FDIC working weekends for years to come without having to resolve a potentially large number of failed S&L's. I am also certain the FSLIC has neither the desire nor the capacity to take over the FDIC's problems.

There should be a more facile procedure for financial institutions to change from one federal deposit insurance agency to another. Historical rationales notwithstanding, asset composition tests seem to be increasingly irrelevant in the modern economy.

USE OF THE DISCOUNT WINDOW AND THE FHLB SYSTEM

Thrifts now have full access to the Federal Reserve Discount window. The various Federal Reserve Banks have been helpful and accommodating to the S&L's. **The time has come to make the many services of the Federal Home Loan Bank System available to all healthy banking institutions.** The ability to borrow on a long-term basis from the FHLB system would only strengthen the banks, help them to reduce interest rate risk, and increase their ability to make long-term loans to homeowners and others.

All the capital and reserves in the FHLB system have been paid directly or indirectly by the thrift industry. **To the extent that there is excess capital in the FHLB System as there appears to be, this capital should be returned directly to the present stockholders of the FHLB system as a special dividend.**

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REGULATORY RESPONSE TO RISK TAKING

Protection of the federal deposit insurance funds and/or the notion of financing home ownership should not be used as the basis to limit the reasonable prerogatives of management or to restrict the ability of institutions to be competitive. We must not forget that the majority of S&L's that went out of business during the early 1980's failed because they were engaged in home mortgage lending as required by law. History has proven time and again that the government is not very good at determining what type of risks management ought to take.

My association in St. George is a classic case of an S&L that had gone broke making residential mortgages. Today, thanks to new capital, the prudent use of brokered deposits and state-granted powers, this institution is now profitable. While this small S&L poses no risk to the FSLIC, the greatest risk it faces is that the FSLIC will successfully restrict the use of insured brokered deposits and direct investment authorities by well-capitalized and well-managed institutions. **Congress should not allow the regulators to repeat the past mistakes of over regulation.**

The best way to protect the integrity of the deposit insurance funds is to; (1) implement an accounting system which accurately discloses the condition of institutions, (2) require that institutions maintain a real capital position, (3) provide a regulatory climate that fosters diversification, and (4) allow management the maximum

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flexibility to respond to the changes in the business environment. This regulatory approach will attract new capital and talented managers to the industry, and will result in less loss for the funds than a return to restrictive regulations.

ELIMINATION OF SPECIAL TAX BENEFITS

The current special tax benefits for the S&L and credit union industries are anachronistic and should be eliminated as part of the overall simplification of the tax code and deficit reduction efforts. The FHLB system should be also be taxed. Special tax advantages for specific industries are an inefficient method to promote public policy or allocate economic resources.

CONCLUSION

I am optimistic that the financial services industry will evolve through the current period of adjustment without major disruption to the public and without taxpayer funds being expended to protect depositors. The continued hard work and good judgement of dedicated people, such as the members of this Committee and those who assist you, will make this prognosis come to pass. Mr. Chairman, thank you for the invitation to testify today and for your support over the years. I especially appreciate the leadership and wisdom you bring to this important Committee and to the Senate.

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The CHAIRMAN. Thank you.
Mr. Carron.

STATEMENT OF ANDREW CARRON, VICE PRESIDENT, SHEARSON LEHMAN BROS., INC., NEW YORK, NY

Mr. CARRON. Thank you, Mr. Chairman.

The condition of our banks and thrifts brings us here today. Despite an economy that has been growing, a reduction in the inflation rate, and lower interest rates, many of our banks and thrifts today are operating at a loss, have insufficient capital, and have uncertain chances for survival.

These developments have raised concerns at both State and Federal levels over the viability of individual institutions and over the future of the industry as a whole. To that end, many proposals have been forthcoming to address the problems: we've heard today discussions of risk-based premiums, risk-based capital, increased disclosure, more stringent enforcement, and so forth. These measures and variations of them have been the focus of the debate up to this point.

S&L'S ARE IN A WEAKENED AND FRAGILE CONDITION

Worthy as such proposals may be, they are not the correct approach at this time. Depository institutions are in a weakened and fragile condition and financial markets are reacting to this situation. To impose new insurance costs or regulatory requirements would further impair these institutions and would risk even greater instability in the markets. The suggested regulatory changes may ultimately be effective in preventing new occurrences of the types of difficulties now being experienced, but they would be counterproductive in the effort to cure the problems that already exist.

If I can use the old analogy, you're locking the barn door after the horses have escaped. Not only is it a futile gesture, but it prevents them from getting back into the barn.

The CHAIRMAN. But don't you try and prevent other horses from escaping?

Mr. CARRON. Yes. Before new regulations are imposed on banks and thrifts, a policy to restore strength and confidence should be implemented and the primary means of accomplishing this objective is to rationalize and reorganize the weakest firms and to discourage the others from assuming excessive risk.

The industry's weakness is only half the story and the regulatory response completes the picture. The policy approach to problem institutions, particularly among thrifts, includes a tolerance of insolvency, blanket regulations that limit both healthy and ailing firms, and a search for long-range rather than short-range solutions. As a result, there may be more risk taking, not less.

Financial markets are becoming less willing to conduct business with all but the strongest lenders in the market and the eventual cost of dealing with the problems may increase.

One widely observed effect of the decline in soundness is an increased propensity to take risks. When an institution's failure appears probable, there is a strong incentive to increase the stakes of the game. Federal deposit insurance provides these institutions

with a source of leverage. When the institution's own capital is gone the leverage becomes infinite. The failing depository seeks not to maximize expected profit, but rather to maximize the probability of success regardless of the cost of failure.

Thus, we see institutions entering into transactions that may be fundamentally unsound but which offer the gamble of recovery. Some firms speculate on interest rates, others on real estate values, but the result is the same.

The regulatory agencies have adopted a policy of forebearance, of permitting many insolvent institutions to remain in operation as long as cash flow is adequate. Only when such an institution faces a liquidity crisis do the agencies act. This practice is followed by the FSLIC and to a lesser degree by the FDIC.

The current level of assets immediately available to FSLIC may be inadequate to cover insured deposits at all insolvent institutions and there would be a major drain on FDIC assets if all problem bank loans were immediately written down.

FSLIC FOREBEARANCE ENCOURAGES RISK-TAKING

This policy of forebearance has the pernicious effect of encouraging more risk taking. Insolvent institutions become ever more leveraged. Nearly insolvent institutions see firms less healthy than themselves allowed to remain in business. Excessive risk taking is not always punished.

From our point of view in the capital markets, we have seen several instances where problem firms caused difficulties for healthy firms:

One, in many parts of the country there is bidding for deposits, and we see institutions paying a premium of up to 1 percent on deposit rates to attract funds, which must be matched by other institutions in order to stay in business.

Two, we see a diversion of regulatory attention to focusing on the continued maintenance of these problem institutions and away from measures which could improve the prospects for the industry as a whole, such as enhancing the charter opportunities, revamping liquidity regulations to take account of new instruments in the marketplace and the like.

Three, regulations designed for this minority of institutions that are in serious trouble can limit the very sound growth of healthy institutions. Brokered deposit limitations would be an example of this sort of regulation. The growth regulations, while potentially effective in limiting risk taking by the weak institutions, will also limit growth where it should take place among healthy institutions.

Four, we also find depressed asset prices because of the threat of problem institutions and the possibility that assets will have to be liquidated in the market. Institutions that engage in these transactions in the normal course of business are not receiving as much in those transactions as they would otherwise receive. Over the course of various crises over the last year in Ohio, Maryland, and California, we saw prices for mortgage assets drop as much as 1 percent and more relative to other assets in the marketplace.

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Five, we see widening spreads in transactions involving thrift institutions. We see investors raising concerns about the creditworthiness of institutions with whom they deal. In some of our transactions with thrift institutions that are rated AAA by Moodys and Standard & Poors, the market treats these as if they were single A and the institutions must pay a premium of 25 to 50 basis points or more.

The policy proposals that have been proposed for preventing these problems would be ineffective in resolving them. Risk-sensitive deposit premiums, for example, would levy higher charges on banks and thrifts with lower amounts of capital. Yet these are the firms least able to afford higher premiums, and therefore the ones most likely to adopt riskier and potentially more profitable investment programs. Increased disclosure or reduced coverage would have the same effect. Curtailing brokered deposits would force institutions to seek higher cost sources of funds, which must then support assets with higher risk and return.

This is not intended to prejudge the usefulness of prudential incentives when applied to a basically healthy industry. A system that discourages risky behavior is definitely needed to maintain financial stability over the long run. But the problems affecting the markets today require different measures.

The regulatory agencies should be more active in dealing with problem institutions. The quality and quantity of Federal and State supervision should be increased. Managers, directors, and owners should not be led to believe that deteriorating capital, excessive risk taking, and other such practices will be condoned.

In the case of institutions regulated by the Bank Board, it will be necessary to establish more stringent standards than exist today. More real capital should be required, and where that is not possible, the agency should step in to assure safe and sound practices. This means a retreat from regulatory accounting and from ever lower net worth requirements. The markets already shun those institutions with no GAAP net worth or with regulatory net worth below 3 percent, and regulatory agencies should do likewise. Only the threat of a takeover by its chief creditor, namely the FSLIC, will deter those who control a weak thrift institution from risking further large sums of money. Such an approach would do much and very quickly to arrest the erosion of health in the industry.

Thank you.

[The complete prepared statement follows:]

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Statement of

Andrew S. Carron

Vice President
Shearson Lehman Brothers Inc.
New York

Prepared for delivery before the

Committee on Banking, Housing and Urban Affairs

U.S. Senate

July 25, 1985

Mr. Chairman and Members of the Committee:

My name is Andrew Carron. I am a Vice President of Shearson Lehman Brothers and Manager of the firm's Mortgage Research and Analysis Department. As part of the Mortgage Securities Group, we assist savings institutions with asset-liability management, portfolio restructuring, mortgage-backed financings, liquidity investments, hedging, and trading. I have also written extensively on financial institution regulation and deposit insurance. My study, *Reforming the Bank Regulatory Structure*, was published earlier this year by the Brookings Institution; I was also a principal author of the Federal Home Loan Bank Board's report on federal deposit insurance submitted to this committee in 1983 pursuant to the Garn-St Germain Act. I therefore welcome the opportunity to present my views on the regulation and supervision of depository institutions.

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Many banks and thrift institutions today are operating at a loss, have insufficient capital, and have uncertain chances for survival. Some savings and loan associations continue to suffer the effects of the high market rates and low returns on assets that prevailed in the late 1970s and early 1980s. Other thrifts invested in real estate or commercial endeavors when economic growth was robust, and now find that those projects are generating insufficient cash flow in today's deflationary economy. Commercial banks that lent heavily to the agricultural, energy, and foreign sectors are also finding that some borrowers are unable to service their debt.

These developments have raised concerns at the state and federal levels over the viability of individual institutions and of the banking and thrift systems generally. Many proposals have been forthcoming to address the underlying problems. Risk-based insurance premiums, increased disclosure, more stringent enforcement, and higher capital requirements have all been suggested. These measures and their variants have until now been the focus of debate.

Worthy as such proposals may be, they are not the best approach at this time. Depository institutions are in a weakened and fragile condition, and financial markets are reacting to this situation. To impose new insurance costs and regulatory requirements would further impair these institutions and would risk greater instability in the markets. The suggested regulatory changes may ultimately be effective in *preventing* the types of difficulties now being experienced, but they would be counterproductive in the effort to *cure* the problems that already exist. Before new regulations are imposed on banks and thrifts, a policy to restore strength

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and confidence should be implemented. The primary means of accomplishing this objective is to rationalize and reorganize the weakest firms and to discourage the marginally healthy ones from assuming excessive risks.

Industry Condition

There is widespread weakness in the banking and thrift industries today. The Federal Deposit Insurance Corporation has 989 commercial banks and mutual savings banks on its "problem list." Federal Home Loan Bank Board economists recently calculated that 434 FSLIC-insured savings institutions were insolvent at the end of last year, according to Generally Accepted Accounting Principles (GAAP). There is little doubt among analysts of these industries that the situation will get worse before it gets better.

The decline in market interest rates since the beginning of this year is often cited as a cause for optimism. The savings industry in particular has reported increasing profits over the last two years. Several points mitigate this apparent improvement:

——Most of the profits have been in the form of nonoperating income rather than operating income. Nonoperating income is generated when the institution chooses to sell appreciated assets rather than discounted assets. For the nine quarters from the beginning of 1983 through March 1985, net pre-tax nonoperating income was $4.0 billion. Operating income on the same basis was only $1.3 billion. (These figures are for FSLIC-insured thrift institutions.)

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——The decline in rates has not been sufficient to compensate for three years of high rates (1980-82) when the industry lost $10.7 billion before taxes. Regulatory net worth has recovered to 4.0 percent of assets, but on a GAAP basis industry net worth is approximately 3.0 percent. Tangible net worth, which excludes goodwill and intangible assets from GAAP net worth, is approximately 0.5 percent of assets.

——The improvement that has taken place is not felt uniformly across the industry. In addition to the 10 percent of the thrift industry with negative GAAP net worth another one-third have net worth below 3 percent of assets.

The majority of banks and thrifts will be profitable, but the weakest institutions will be helped little by lower rates. Their problems are too large, and are generally unrelated to the level of rates. For the thrift industry, this reflects a change from a few years ago, when short-term high-cost liabilities had to support long-term low-rate assets. The problem today for most of the banks and thrifts in trouble is poor quality assets--that is, assets whose cash flow is insufficient to meet the debt service. Low market interest rates do not help the situation; in fact, they are a symptom of the larger problem. The deflationary economy that permits lower interest rates also retards growth in nominal incomes for farmers, real estate investors, energy developers, and foreign creditors. Lower inflation also depresses the value of the assets pledged to support many of the loans held by depository institutions. This, then, is the heart of the asset quality problem.

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Regulation and Supervision

The industry's weakness is only half of the story; the regulatory response completes the picture. The policy approach to problem institutions, particularly in the thrift industry, includes a tolerance of insolvency, blanket regulations that limit both healthy and ailing firms, and a search for long-range solutions. As a result, there may be more risk-taking, not less; the financial markets are less willing to conduct business with all but the strongest lenders, and the eventual costs of dealing with the problem may increase.

A widely observed effect of the decline in soundness is an increased propensity to take risks. When an institution's failure appears probable, there is a strong incentive to increase the stakes of the game. Federal deposit insurance provides a source of leverage; when capital is gone, the leverage becomes infinite. The failing depository institution seeks not to maximize expected profits, but rather to maximize the profitability of success regardless of the costs of failure.

Thus we see institutions entering into transactions that are fundamentally unsound, but which offer the gamble of recovery. Some firms speculate on interest rates, others on real estate values. The result, however, is the same.

The regulatory agencies have adopted a policy of forbearance, of permitting many insolvent institutions to remain in operation as long as cash flow is adequate. Only when such an institution faces a liquidity crisis do the agencies act. This practice is followed by the FSLIC and, probably to a lesser degree, by the FDIC as well. The current level of assets immediately

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available to the FSLIC may be inadequate to cover insured deposits at all insolvent institutions, and there would be a major drain on FDIC assets if all problem bank loans were immediately written down.

This policy of forbearance has the pernicious effect of encouraging more risk-taking. Insolvent institutions become ever more highly leveraged. Nearly insolvent institutions see firms less healthy than themselves allowed to remain in business. Excessive risk taking is not always punished.

Policy Proposals

The measures that have been proposed for preventing these problems would be ineffective in resolving them. A system of risk-sensitive deposit insurance premiums, for example, would naturally levy higher charges on banks and thrifts with lower amounts of capital. Yet these are the firms least able to afford higher premiums, and therefore the ones most likely to adopt riskier (and potentially more profitable) investment programs in response. Increased disclosure or reduced insurance coverage would have the same effect. Curtailing brokered deposits would force institutions to seek higher-cost sources of funds, which must then support assets with higher risk and return.

It should be noted that any plan intended to "tax" risk will have two effects that are opposite in their impacts on risk-taking. On the one hand, the rate of return on risky investments is reduced relative to safe investments; economists call this the substitution effect, and it leads to less risk-taking, all other things being equal. On the other hand, the imposition of higher charges for the riskier investments reduces the overall

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profitability of the firm, leading to the adoption of a riskier stance to make up the higher costs; this is the income effect. Whether the substitution effect outweighs the income effect, and therefore is successful in reducing risk, depends on the size and structure of the insurance premiums. It is by no means obvious that any such system can reduce risk-taking by undercapitalized institutions.

This is not intended to prejudge the usefulness of prudential incentives when applied to a basically healthy industry. A system that discourages risky behavior is definitely needed to maintain financial stability over the long-run. But the problems affecting the markets today require different measures.

The regulatory agencies should be active in dealing with problem institutions. The quality and quantity of federal and state supervision should be increased. Supervisory agents need the training and the resources to understand more completely the wide variety of activities that banks and thrifts now undertake. They need the ability to support management's constructive efforts and the authority to forestall practices that are unsound. Managers, directors, and owners should not be led to believe that deteriorating capital, excessive risk-taking, and other such practices will be condoned.

In the case of institutions regulated by the Bank Board, it will be necessary to establish more stringent standards. More real capital should be required, and where that is not possible the agency should step in to assure safe and sound practices. This means a retreat from regulatory accounting and from lower net worth requirements. The markets already shun those institutions with no GAAP net worth or with regulatory net worth below 3 percent; regulatory agencies should do the same. Only the threat of a takeover by its chief creditor (the FSLIC) will deter those who control a weak institution from risking further large sums of money. Such an approach would do much, very quickly, to arrest the erosion of health in the industry.

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The CHAIRMAN. Mr. Warner.

STATEMENT OF ARTHUR E. WARNER, DIRECTOR AND PROFESSOR, CENTER FOR REAL ESTATE AND URBAN ECONOMIC STUDIES, UNIVERSITY OF SOUTH CAROLINA

Mr. WARNER. Thank you, Mr. Chairman. I appreciate your invitation to be here today.

I find myself in the cleanup position and although it's an unusual one for a professor, I am going to make my remarks as brief as possible, and I mean brief.

At the outset, I must add a footnote to one of Dick Pratt's comments when he referred to college professors as questionable risks in the marketplace. I am assuming he is talking about others than those who are present here today.

Seriously, to bring us to conclusion, I would simply make a brief comment about the conclusions that I reached in my brief statement to the committee where they have been touched upon by almost every other speaker this morning, a number of which I quite subscribe to. But in the main, Mr. Janis wrote the script that as closely paralleled mine as any, so basically—and Jay said it a heck of a lot more eloquently than I, but fundamentally, our FSLIC has performed nobly for us for the last 51 years and we shouldn't lose sight of this when we move forward.

ESTABLISH THE LEVEL PLAYING FIELD

One appeal that I've made that I don't know that others have is any changes that this committee considers developing and recommending through the legislative processes in my view should retain that move toward establish the level playing field which was included in the deregulation act, especially in the act that bears your name in part, Mr. Chairman. So in this regard, we've had a system that's operated very effectively for more than 50 years. Let's not move in haste to completely restructure it and throw it out.

Then very quickly, there is simply no merit for discussion of merging FSLIC with FDIC. I simply cannot find it. No economies of scale as we look at it in economic terms would accrue. The illusion of short-term accessibility to funds that are greater than those available to FSLIC I submit are illusory and may be questioned. As my colleagues here at the table just referred to, we have a sizable number of loans by commercial banks that are out there that are in nonearning categories, and one of the largest commercial banks in the country has found a way to absorb almost one-half billion dollars in losses, a lot of which related to real estate type lending just in recent weeks.

So a merger, looking at it in a detached way, I've been in the academic environment for all of my career. I have no ax to grind. I am not representing any agency, any constituency other than myself, and what I view this general public here that lives outside the beltway, and then my comments about the variable deposit insurance go along the same way. My academic colleagues, a lot of them, have viewed this with intrigue and said it's a great idea. I am really concerned about the capacity to make those necessary judgments except after the fact. And here retrospective assessment

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of risk and thereby varying the premiums is a system that I submit we would not tolerate in the United States.

Finally, there's no question in my view, as has been mentioned by others, that there's no private insuring agency that can assume the responsibility for providing deposit insurance in the United States. The public, if they've indicated anything for us, the individuals, the households, the savers who use the facilities of the financial institutions, and particularly the thrifts, in my view, in Ohio and in Maryland, a few years ago we may recall we had the first problem cropped up in the State of Mississippi with a Mississippi firm. All of this clearly to me indicates that there's no way that a private insurer is going to provide the service. It comes right back eventually to the full faith and credit of this United States of ours that rests in your committee, in the Congress, and the executive branch that the people in the United States implicitly look to in their recognition and use of the depository financial institution whose continuing service to our economy without any question must be maintained.

Thank you, Mr. Chairman, for permitting me to join you here today. I've enjoyed it very much. I may have some stories to go back to share with my students so they may have to suffer some longer times in the classroom that I'm going to submit the people in this room today. Thank you.

[The complete prepared statement follows:]

STATEMENT OF ARTHUR E. WARNER, CHAIR PROFESSOR OF REAL ESTATE AND PROPERTY FINANCE, UNIVERSITY OF SOUTH CAROLINA, COLUMBIA, SC

Mr. Chairman, my name is Arthur E. Warner. I thank you for providing me the opportunity to appear before this important committee this morning. My statement covers topics of concern to the savings institutions industry including the Federal Savings and Loan Insurance Corporation, the proposed merger of the Federal Deposit Insurance Corporation and the FSLIC, proposals for variable risk deposit insurance premiums and substitution of private deposit insurance for federal insurance. I will limit my remarks to a brief commentary on these issues.

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

The concept of insuring deposits in regulated depository financial institutions has been around for a long time. The state of New York, for example, provided bank note deposit insurance as early as 1829. Several other states copied the New York experience during the nineteenth century. Federal involvement did not arise until the advent of the Great Depression in the early 1930's. Following the nationwide bank holiday in March, 1933, deposit insurance become a part of the Federal system. The goals of deposit insurance are generally recognized to include protection of the money supply,

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protection of the payments mechanism and protection of the savings of small depositors. In my view, the overriding role of deposit insurance is the public confidence instilled by the insurance scheme.

In this context, it is noteworthy to observe that the FSLIC has served its purpose magnificently during the last half century of its existence. Since its beginning in 1934 when it was created as a part of the National Housing Act of 1934, FSLIC has inspired and maintained public trust and confidence to the extent that to this day no depositor has lost one penny in an insured deposit or account invested in a thrift institution. This impressive achievement merits recognition by this Committee and the Congress when any changes in the deposit insurance system are being considered. While problems exist regarding the continuing effectiveness of the insurance function, their resolution does not require massive changes. Some restructuring along the lines proposed by the Federal Home Loan Bank Board probably is necessary. Any changes that are made should meet the test of maintaining the "level playing field" of competition among the regulated depository financial institutions that was provided by the deregulation acts of 1980 and 1982.

PROPOSED MERGER OF FDIC AND FSLIC

The proposal to merge the two primary deposit insurance agencies is, in my opinion, without merit. In the first

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place, no economies of scale would be gained by such a move. Costs associated with regulation would not necessarily be lowered and it is doubtful that any other efficiencies would be forthcoming. Also, the missions of the regulated institutions are sufficiently different to retain separate identities for the insurance agencies. One of the strengths of the savings institution industry during the past fifty years has been the unitary system that unites the functions of chartering, regulating, liquidity and insuring under the organizational control and responsibility of the Federal Home Loan Bank Board.

With regard to this issue, I agree with the recommendation of the report of the Task Group on Regulation of Financial Services chaired by Vice President George Bush as reported in Blueprint for Reform, July 1984.

PROPOSALS FOR VARIABLE RISK DEPOSIT INSURANCE PREMIUMS

Proposals to strengthen the deposit insurance system and provide for more equity in paying for risk differentials through establishment of a variable risk premium mechanism have been debated in academic circles for some time. On a theoretical level those proposals have considerable appeal for it is generally recognized in the financial marketplace that higher risk is compensated by higher prices. Transferring this market mechanism to the public regulatory sector, however, poses problems and raises questions for which I do not foresee any immediate answers. To provide adequate insurance reserves

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for a variety of perceived risks requires answers to several questions. For example, how are risks to be classified, which are greater than others, what criteria will be used in ranking risks and determining how much to charge for different levels of risk? Answers to these questions simply are not available today. The experience of the insurance industry based on years of observation is not available to provide the necessary guidelines for imposing variable rates on deposit insurance premiums. At this moment in time, I submit, the best guide available is after the fact. Even if a device for assessing risk premiums retrospectively could be constructed, I doubt that it would be workable.

It is noteworthy that the Bush Task Group's recommendation concerning risk-related insurance premiums was hedged with the admonition that the insurance agencies should be required to utilize measurements of risk developed by the private sector to the greatest extent possible. Since such measurements of risk do not exist, we are left with a "catch twenty-two" situation.

Under these circumstances, it might be appropriate to test a limited experimental program of supplemental premiums on loans and investments in certain areas where the thrift institutions have had limited experience in the past.

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SUBSTITUTION OF PRIVATE DEPOSIT INSURANCE FOR FEDERAL INSURANCE

Among the proposals made to reform the deposit insurance system, the specious notion that private insurors could replace the present federal agencies in insuring deposits is totally without merit. Since retention of public confidence and trust in the insurance system is paramount, it is not possible for a private insuror, even one financially strong, to retain public confidence during times of crisis. The recent experience in the states of Ohio and Maryland, together with the Mississippi episode a few years ago clearly indicate that the public at large places little, if any, confidence in private insurance funds even when they are linked to the state. In the mind of the ordinary citizen federal insurance with the implied "full faith and credit" support of the United States Government is a necessity.

CONCLUSION

In conclusion to my remarks, Mr. Chairman, my comments may be summarized as follows:

1) the FSLIC has performed satisfactorily for more than fifty years and any changes made in its structure should preserve the "level playing field" established under the 1980 and 1982 deregulation acts;

2) the FSLIC should not be merged with FDIC;

3) variable risk deposit insurance premiums should be approached cautiously and slowly;

4) substitution of private deposit insurance for federal insurance is totally without merit.

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The CHAIRMAN. Thank you, Mr. Warner.

First of all, let me say the same thing to you that I said to former Chairman Janis. Don't worry about us doing anything in haste. Many of the things that I have been talking about doing in the last 5 years since I have been chairman were issues that were kicking around this Congress and this committee before I even became a Senator, let alone chairman. It's very rare that we do anything quickly.

On the other side of the coin, I would say that we do it too slowly. The marketplace changes so rapidly and we have not responded to the technological revolution that is going on out there or the homogenization of various types. I think the criticism would be much more on the opposite side, that we don't act rapidly enough most of the time.

But let me pursue what has been going on through 2 days of hearings now. I understand your cautions about getting into a system of risk-related premiums, but I also cannot help but think back at the time when insurance companies first got away from just the little neighborhood groups and had some very grave questions about how to rate human beings for life insurance. I would assume that they looked at it in the same way. How are you going to tell? Well, you started and you worked with it and you massaged it. The actuarial tables became much more sound as we have seen casualty insurance develop. How in the world do you write flood insurance? How do you write all sorts of different types of risks? How do you rate an 18-year-old versus a 52-year-old and all of that?

NEED TO PROCEED WITH LEGISLATION

I don't discount the problems in trying to devise it, but I think we must proceed even if it's on a limited basis. I really do feel that there is an incredible element of unfairness, once again to repeat myself a third or fourth time today, in those well-run or prudently run institutions that have to pay for others who are taking a lot of risks that they should not be taking.

Would you agree that, although it is difficult to view exactly what type of a system that we would eventually devise, they're not insurmountable. Probably in some ways it would appear to me not as difficult to devise as looking at a nation of human beings and trying to assess risks to what their health risks are and whether they're going to survive to age 70 or 25?

Mr. WARNER. Yes, sir; Mr. Chairman. As I noted in my brief statement, I suggested that we should go cautiously but proceed on an experimental basis to begin to collect the experience that will give us the basis to provide some answers to these very difficult questions about what is risky and how much you charge for different levels of risk.

The experience in life insurance and casualty experience clearly has come about over a long period of years and now in the life area in particular our actuarial capacities are really quite impressive. So we must begin.

But at the same time, I would note that to the best of my knowledge, the only area we have anything close to relating to the experience or a move in that direction is in the efforts of Standard &

Poor, as they have already developed a system for rating securities using loans on office buildings as collateral. This is a small step forward we're talking about, but the only experience that we really have is just getting underway with this one limited case, and we don't have much in the way of experience, much data yet. So it's going to take some time. But I certainly say, by all means, let us begin but let's not try to do it all at once in one fell swoop.

The CHAIRMAN. Well, I don't think it's possible to do it all at once if you're talking about a detailed, very refined system, but there's no disagreement in this group of witnesses that I've heard or anybody else I've talked to that direct investment in real estate has been a real problem.

Mr. WARNER. It's probably the most severe one.

The CHAIRMAN. There are probably categories that it is not difficult to decide and you tell them, "If you go into that, fine, but you're going to pay for it." There are certain categories that are very evident to us that are much more risky than others.

Mr. Beesley, you headed the FSLIC during one of the most difficult times in its history. What's your opinion of this whole subject of changing it, revising it? What direction would you go if you had the opportunity all by yourself to say "I ran the place." What would you do to change it if you were going to come back and wanted to run an institution that was tailor made for your ideas about providing safety and security for people's money?

Mr. BEESLEY. Mr. Chairman, I was one of the first I think to jump on and in fact start the bandwagon on variable rate deposit insurance. I think it's a good idea and it is fair, but it's not going to keep people from dying. It's going——

The CHAIRMAN. Well, neither does life insurance.

Mr. BEESLEY. No, it doesn't. I think that is very important. I'm a little uneasy when this becomes the cornerstone of a regulatory policy because while it will add fairness, it's not going to be a panacea.

I think the thing that I would try to do and did try to do at the FSLIC was to develop a system to tell me what risks an institution really had so that I could deal with them. It just drove me crazy when we would have a situation where an audited financial statement said the net worth was zero and we went in and had a $500 million or a $200 million loss. We had no way of assessing, and they still have no way of assessing, the risks of the institutions that they are attempting to insure.

So the first thing I would try to do would be to get a system in there that would let me understand what risks I've got so that I can deal with them. It's hard to get from where we are to this point, especially when the interest rates were where they were in 1980 and 1981, but it may be possible today to close institutions, as Mr. Carron suggested, when they reach a point where they no longer have any capital at risk and get them out of there so that they don't go on increasing our costs and disrupting the marketplace.

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REMOVAL AT ZERO NET WORTH

If we had a policy again of removing institutions at the time real net worth equals zero, we would never have a loss at the FSLIC, and we shouldn't have a loss. If we had accurate systems and the courage to move, there would be no reason to take a loss.

The CHAIRMAN. In your testimony you refer to the excess capital in local Federal Home Loan Banks. Could these funds be used to help resolve the FSLIC's future need for increased funds?

Mr. BEESLEY. Mr. Chairman, I know the Presidents of the Federal Home Loan Banks don't believe they have excess capital, but if you look at the money center banks and the capital ratios they carry and the enormous risks they carry and their ability to attract funds at reasonable prices, it would seem that a 10-percent capital ratio at the Federal Home Loan Banks where they have virtually no risk of loss is indeed in excess of their requirements, probably by $5 or $6 billion.

And if Congress felt it appropriate to use these funds for the FSLIC, it seems to me that it's available.

In my written testimony I suggest that the money be given back to the thrift industry because I am not one who believes that the FSLIC, at this point anyway, necessarily needs more than the $200 million a month that it's currently getting in income.

Senator Proxmire threw out a $16 billion figure as to the difference between the value of assets and liabilities of institutions that are perhaps on the docket. That figure would equate to the cost of liquidation, and we were solving cases in a much more hostile environment at about 20 percent of the cost of liquidation which would be about $3.2 billion. That's a 16-month cash flow at the FSLIC.

The CHAIRMAN. Well, that was the point I was trying to make. We weren't going to liquidate all at once and we certainly would not have all of those institutions requesting at the same time.

Mr. BEESLEY. I think there's a point that may not have been emphasized sufficiently in my testimony. I am not attempting to say that the FSLIC was better managed at one point in time or another point in time, but my feeling is that it is not as well-managed or has never been as well-managed perhaps as it could be, to resolve the kinds of crises and problems that it has to deal with today. It would take not only King Solomon but perhaps all the Solomon Brothers to deal with the problems that it's got and it just doesn't have the human resources to get the job done in the most cost-effective manner, as Chairman Gray I think would be the first to admit.

The CHAIRMAN. Mr. Carron, what do you think? Do you think there's excess capital out there in the local home loan banks?

Mr. CARRON. There may well be. I haven't studied that. I leave that to my colleague over here who has. To the extent that there is, I would favor his approach of devolving it back to the members of the bank system and then if it was decided to tap those resources for the FSLIC you would impose it in the form of higher premiums on the institutions rather than to just short circuit it from the bank system to the FSLIC.

SWITCHING TO CURRENT VALUE ACCOUNTING

The CHAIRMAN. Mr. Beesley, how difficult would it be to move toward a regulatory use of current value accounting?

Mr. BEESLEY. In the case of my institution, if we went to current value accounting, the net worth would go up, and there are others I think that are in the same boat. Right now the yield on the mortgages in savings and loans is very close to the market rate on new mortgages that are being originated and so we have a window of opportunity to perhaps go to current value accounting.

It would require an enormous discipline on the industry because they would have to prepare themselves through matching their assets and liabilities and other hedging mechanisms to be prepared for the next spike in interest rates which they're absolutely not prepared for today.

So it would require a lot of education and a lot of discipline. It's perhaps something that can't happen overnight, but if we don't go to that or some derivation of current value accounting we're never going to really have the problem in tow.

The CHAIRMAN. Dick Pratt suggested in his testimony a shared cost method of deposit insurance which would create a percentage of deposit deductible. Deductibles are certainly commonplace in insurance. Mr. Warner, you shake your head no.

Mr. WARNER. Mr. Chairman, that frightened me somewhat when I heard a thoughtful and knowledgeable person like Dick Pratt say it and I'm not exactly certain that I can express all of my intuitive uneasiness, but I guess what bothers me is the public has not perceived itself as a sharer of risk when my mother or my grandmother or any of us placed our funds in a thrift institution. I simply do not believe that there is the sophistication of the understanding of what they're doing on the part of a sizable fraction of our savers that Dick in some ways is attributing. Now he may know a lot more about this and maybe in Utah this is the case, but I'm from Indiana, although I live in South Carolina, and I feel confident that the Hoosiers I know do not have this level of sophistication.

I just would be—unless it was imposed upon all regulated depository institutions—I'm back to my level playing field again—where nobody had any choice, then it might work because we would have to make it work. We're going to use our financial institutions or we're not going to use them as individuals and we're not going back to putting our savings under the mattress or burying them in a tin can in the backyard as I can recall in the depths of the depression back in the 1930's.

So this is where I'm coming from in terms of my uneasiness about this suggestion that I'm sure that Mr. Pratt has thought this through a good bit more than we've had the opportunity here just since we heard it this morning.

The CHAIRMAN. Mr. Beesley, what do you think about deductibles?

Mr. BEESLEY. Mr. Chairman, I agree with Dick, and we've discussed it at great length, and it's discussed in the "Agenda for Reform" at great length. It makes sense, but I can't feel comfortable in this particular environment where we've got so much instability and so many cases to deal with that it's the right time and

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place to stir the pot with regard to putting the depositor at any risk or with regard to, for that matter, increasing the disclosure of routine regulatory actions or things of this nature.

They're ideas that will be appropriate in a more stable environment, but I think right now where we have the number of problems we've got to deal with we ought to try to smooth the waters as opposed to ruffle them.

HINDSIGHT ON THE $100,000 INSURANCE LEVEL

The CHAIRMAN. Do you think we made a mistake back in 1980 when we increased the insurance level to $100,000?

Mr. BEESLEY. I don't. I think that the insurance of accounts level is almost irrelevant in an environment of rapid technological ability to disperse your money in a million different directions. I don't think that was a big mistake.

The CHAIRMAN. The reason I asked that question is because I do, and I was part of it.

Mr. BEESLEY. Really?

The CHAIRMAN. I sat here in this very room when we worked out the compromise. People were talking about making it $60,000 or $80,000 and we went to $100,000. Because of the climate at that time, we wanted to instill some confidence. I still think from that standpoint it was the right thing to do out there in the marketplace, but from the standpoint of what we've gotten into now—hindsight is always so good—I wonder if it hasn't encouraged a lot of the so-called go-go or slipshod operations that think, "Well, we take this risk, big deal. Our depositors are taken care of up to $100,000." That's the reason that I sometimes think that we made a mistake and made it too high. It's a cover for sloppy operations.

Mr. BEESLEY. Mr. Chairman, I think if it had been $50,000 or $25,000 it would merely mean that these high flyers would have to have one or two more technicians to keep track of the additional accounts. They would get the money. They would just have more people involved in the process.

The CHAIRMAN. Well, if you assume that they could attract more depositors with people spreading them around to keep it under the insurance amount, I think it would make it more difficult for them to attract that.

Mr. WARNER. Mr. Chairman, may I just make one observation? Along these lines, what is the magic of stopping our insurance of deposits at maybe not $100,000 or if that's the limit, a lot of these expensive deposits are the jumbo certificates that are larger than $100,000 and they are the type that relate to the hot money that tends to cause some problems. If we don't insure these jumbo deposits, one suggestion that has just occurred to me more than once, let them pay premiums on them and this could help the insurance fund.

Now that may sound rather revolutionary for an old college professor, but why let them escape? They are getting a free ride on all of those jumbo deposits because for the commercial banks and thrift institutions that full faith and credit that comes right here from this Hill is involved whether you have the specific insurance coverage or not. We're paying for them. And then I would go

abroad and get all of those deposits that are offshore under the umbrella, how many trillion or hundreds of billions are we talking about that are primarily in the commercial banking system? I admit I'm meddling because I don't profess to be any expert at all in any area, but certainly not in the commercial banking side. But we've got a lot of deposits out there that are simply not covered by insurance premiums and they are de facto covered by our Federal establishment.

The CHAIRMAN. Gentlemen, thank you for your patience. It's been a long, long morning and we appreciate your willingness to stay and be the cleanup witnesses this morning—or this afternoon. Thank you very much.

The committee is adjourned.

[Whereupon, at 1:05 p.m., the hearing was adjourned.]

[Response to written questions of Senators Garn and Proxmire follow:]

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RESPONSES BY H. BRENT BEESLEY

TO QUESTIONS BY SENATOR JAKE GARN

REGARDING DEPOSIT INSURANCE REFORM

NOVEMBER 8, 1985

1. What is your view of the National Council Task Force's proposal for risk-based net worth and a definitive time frame for an institution to come into compliance, or find a merger partner, or be placed into receivership?

Capital adequacy is vital to the overall strength of the financial system, and the notion of a risk-based capital requirement is theoretically sound. Given the difficulties in accurately defining risk and understanding the volatile nature of risk, it is my opinion that a risk-based net worth requirement does not offer sufficient advantages to overcome the many problems associated with its implementation. A more simple and effective solution would be to require an appropriate level of real capital for all financial institutions with additional specific requirements on a case by case basis if abnormal risks are identified within a given institution. Reality requires that there be a phase in period to allow institutions to reach the established level of capital, but it would not be prudent at this time to legislate what the exact consequences are of falling below the required level. Unfortunately, the existing regulatory system may not be able to properly resolve the potential number of receiverships that could result if the capital requirements were strictly enforced.

You will recall that during the period of my tenure at the FSLIC, over 80% of all S&L's had no "real capital." The number of failures during that period was a function of the resources available to handle cases. Numerous institutions continued in the marketplace without capital even on a GAAP or RAP basis. That same situation continues today due to the lack of managerial resources at the FSLIC to deal with the problems. Ideally financial institutions should not be allowed to exist without real capital at risk, but it will take a significant change in the present regulatory environment before all failed firms can be removed on a timely basis.

2. With regard to the proposed asset management subsidiary, is the real advantage the ability to manage problem assets outside the ceiling of federal pay caps? Isn't a disadvantage that the value of such assets would decline if they had to be disposed of on a stand alone basis -- as opposed to being in a package of good assets and solid customers to be sold as a going

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concern? What are the pros and cons of one asset management subsidiary versus twelve?

The new Federal Asset Disposition Association (FADA) is a potentially effective tool, the use of which I have advocated since 1982. Management will be the key to its success, and the freedom to pay competitive salaries should facilitate the ability of the FADA to attract competent personnel. In my opinion the removal of the "problem assets" from failed associations will generally result in a higher price being offered to the FSLIC for the deposits and remaining assets of the failed firm. Further, the FADA will be in a better position to handle complex foreclosures, complete unfinished projects and market the assets assigned to it. The FADA will receive only those assets that the FSLIC deems appropriate after a review of the marketability of each case involved.

I strongly support the notion of a single FADA. The problem assets of any given failed S&L will often be spread across the entire United States. More importantly, it will be difficult enough to staff, manage and control a single FADA. I see no advantage to twelve FADA's other than to assuage regional politics. Management of the FADA, however, may rightfully find it necessary to open one or more temporary field offices to deal with a large number of assets concentrated in a given locale.

3. If a substantial amount of the Home Loan Banks' assets consisted of loans to the FSLIC, could this severely lessen the willingness of the private sector to invest in a Home Loan Bank's debt instruments? Why or why not? Currently what is the total excess debt capacity of the regional Home Loan Banks?

I believe the question is one of what interest rate the public will demand from the Federal Home Loan Banks (Banks) rather than whether the public will or will not invest in the Banks' debt instruments. As the public's perception of risk is increased, the interest rate that the Banks must pay relative to the United States Treasury will increase. If the loans from the Banks to the FSLIC are viewed to be potentially uncollectible, the amount of these loans will be subtracted from the capital of the Banks by the investment community. It is my view that the Banks have substantial excess capital relative to the major money center banks and that the Banks could reasonably loan several billion dollars to the FSLIC without causing a significant increase in the Banks' cost of funds. If the Congress saw fit to provide a Federal guarantee to the FSLIC's borrowings, it would reduce the interest rate paid to the public by any direct borrowings of the FSLIC or indirect borrowings through the Bank's. This would reduce the ultimate exposure of loss to the

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Treasury.

4. At what point would loans from the Home Loan Banks begin to impair the confidence of the private sector investors in the Home Loan Banks' debt obligations.

The future confidence and comfort level of the investment community can not be easily assessed, and it is beyond my abilities to establish the point at which the confidence would be impaired. By watching the premium over Treasury obligations that the Banks must pay, the public's confidence level can be assessed after the fact. If the borrowings by the FSLIC from the Banks are secured or guaranteed, it may be that the Banks could advance several billion dollars without any loss of public confidence in the Bank's debt obligations. The prudent way to approach Bank advances to the FSLIC would be for such loans to be made in small amounts at first so that public reaction could be observed and analyzed over time.

5. The primary supervision of thrifts has already been delegated to the local Federal Home Loan Banks. If the disposition of problem institutions were also delegated to the local banks, what would be left for the Bank Board? Wouldn't there be a danger of the Bank Board losing control?

The Federal Home Loan Bank Board's (FHLBB) role has always been to provide direction and policy. By necessity, it has always been the staff that has done the actual supervision and the actual disposition of the problem cases pursuant to the direction, policy and approval of the Board. I have long supported the notion of delegation of these tasks from the staff in Washington to the staff in the field. Not only is the ability of the Banks to pay a market salary for personnel an important factor, but the Banks are closer to the situation and can respond in a more timely manner.

There is a very important need for a strong FHLBB to establish uniform guidelines for the national thrift industry and to provide oversight of the Banks. This need has never been greater than it is today. There is indeed a real danger of the FHLBB losing control to the Banks. The strength and personality of the chairman of the FHLBB is the most important single factor in the equation as it now exists. As more and more tasks are delegated to the Banks, it may be necessary to provide the FHLBB with additional tools to maintain its control over Banks and the industry.

6. Should the FSLIC require its insureds to make a one percent deposit in the fund? Why or why not?

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There is no evidence in the public domain that giving the FSLIC more money is required at this time or that such an infusion would solve the problems facing the FSLIC. I consider the problems of the FSLIC to be to a large extent the problems associated with management. The FSLIC's organizational and management problems must be resolved before $8,500,000,000 in precious capital of the S&L industry is subjected to a potential loss at the hands of the FSLIC.

There has been much discussion and testimony on how to recapitalize the FSLIC. I am aware of very little candid discussion on the issue of how the FSLIC is managing its current resources. Without the ability to attract and keep the best talent available, the FSLIC will always be handicapped in dealing with the very complex matters that have been thrust upon it in recent years.

7. If the FSLIC and the FDIC funds are not merged, where will the FSLIC obtain sufficient funds to deal with its problems over time?

The funds to finance the functions of the FSLIC will have to come from the insured institutions in the form of premiums. The costs must be spread over a reasonable amount of time, but most importantly, the costs of resolving cases must be reduced. Had historical methods and costs of resolving problem cases been used during the period the Pratt Administration at the FHLBB, the funds of the FSLIC would have been exhausted in 1981. By cutting these costs to about 17% of the historical average, the FSLIC fund grew in 1981, 1982 and 1983. The FSLIC must seek new and creative ways of resolving the difficult cases it now faces. It is my opinion that giving the FSLIC a large amount of new funds will remove the present incentive to find new and better ways of resolving the problems it faces.

8. With regard to other forms of market discipline by uninsured depositors and general creditors, it is argued that the market discipline is fickle, is trendy. Indeed, it is argued that a run is the ultimate form of market discipline. How do you respond to these concerns?

These are valid concerns. I believe that ultimately there needs to be more market discipline built into the deposit insurance system. Currently, however, the thrift industry is in a period of transition during which hundreds of S&L's must be carefully removed from the marketplace. This difficult period requires that every effort be made to maintain public confidence

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at the highest level. Now is not the time to increase the risk of depositors in the thrift industry.

9. Should the FSLIC be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed bank with any profit after administrative costs arising from the transaction returned to the original stockholders?

Such a proposal is fraught with problems and offers few advantages. To the extent the FSLIC uses its extraordinary powers to provide a solution for a failed S&L, the economic value of such an action should not accrue to the benefit of stockholders as such benefits are not available for stockholders of healthy firms. The FSLIC should not have to be concerned about any fiduciary duties to stockholders but should be unconstrained in its ability to divide, liquidate or otherwise dispose of any failed firm in the manner that the FSLIC deems to be most appropriate.

I do believe that the FSLIC should not be compelled to wait until GAAP or RAP net worth reaches zero before taking control of a stock association. It is my opinion that eventually the FSLIC should take over any institutions before the FSLIC is faced with a loss. Associations should be closed before the time that the value of their assets equals the sum of their liabilities and the administrative costs associated with the liquidation. Of course, a variety of supervisory efforts, including a search for a merger partner and/or new private capital would precede such action by the FSLIC.

10. If the burden of mismanagement was placed squarely and directly on the managers and stockholders, is it necessary to punish depositors and borrowers in order to achieve an improved supervisory system? If failures were handled through a purchase and assumption or forced merger at an earlier stage, regardless of size, wouldn't this dispose of the fairness question as it relates to large and small institutions?

Capital should always provide a cushion of protection for the depositors and borrowers. Unfortunately, the problem arises when the capital is long gone. Punishment of depositors and borrowers is not the issue. The question is how to allocate fairly the loss that has not been covered by the capital. It is my opinion that uninsured depositors should bear a portion of that risk. The earlier the appropriate supervisory action is taken, the less likely there is to be a great loss. I am not optimistic, however, that regulators will have the courage,

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without clear legislative direction, to take the final supervisory action of closure before GAAP or RAP net worth has been exhausted and certainly not before real net worth has been reduced to a negative figure.

11. In your opinion, what are the advantages and disadvantages of risk-based capital and risk-based premiums? Should we consider one or the other or both?

Careful consideration should be given to both proposals. In my opinion a risk-based capital requirement would be difficult to implement as a practical matter. All institutions should be required to have a minimum level of capital and to maintain specific reserves for any potential losses inherent in that institution. I endorse the notion of risk-based premiums. Although this proposal has many of the same problems of defining and measuring risk that are inherent in the risk-based capital concept, the payment of an additional premium based on risk is a far less significant event for an institution than changing an institution's level of capital.

Risk-based premiums are a step in the right direction, but no reasonable premium structure is going to have a dramatic impact on the health of the S&L industry or the FSLIC. One of the benefits of a risk-based premium structure is to allow the FHLBB to focus the attention of management on various areas that the FHLBB considers to be important.

12. There appears to be strong support for risk-based capital in some form. Some suggest an adoption of risk-based capital by the federal insurance agencies would give them the necessary authorities to regulate the activities of state-chartered institutions without granting the authority to override a state legislature. What is your view?

Unfortunately there is no accurate measure of either capital or risk. Some institutions have done very well utilizing certain state-granted powers while other institutions have incurred significant losses using the same powers. The FHLBB's present regulations restricting direct investments to 10% of assets without supervisory approval should put to rest most of the issues involving the powers of state-chartered institutions. I support the general proposition that any institution that fails to meet the required net worth standard should require special supervisory approval for virtually any extraordinary activity.

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13. How would you recommend resolving the dilemma to the dual banking system created by states authorizing activities which place the federal insurance agencies at risk?

The present regulatory structure requiring supervisory approval prior to the utilization of extraordinary state-granted powers in excess of 10% of assets appears to limit substantially the exposure of the federal insurance funds. The ideal manner for the federal deposit insurance agencies to avoid risk from state-chartered institutions as well as federal institutions is to require significant levels of real capital and to take early and decisive action when those levels of capital are breached.

14. Do you believe that the FHLBB and/or FSLIC needs increased enforcement authority? If so, in what areas?

I am not aware of any specific new enforcement authorities that are actually needed. If the FHLBB considers that it needs new powers, then legislative action may be required to give the agency the comfort it needs to do the job. Likewise, I am not aware of any significant reason why the additional supervisory powers requested by the FHLBB should not be enacted.

15. Does the Community Savings and Loan and EPIC problem reinforce the need for certain activities to be engaged through a subsidiary of the holding company rather than a subsidiary of a depository institution?

Blanket prohibitions against any type of non-traditional activities by depository institutions and/or requiring such activities to be conducted by a subsidiary of the holding company would prevent certain losses but create other problems particularly for institutions that do not have a holding company. A more enlightened approach in my opinion is to allow healthy institutions to take those risks which management deems appropriate. This approach requires proper supervision. In most of the situations such as EPIC that have come to light recently, there appears to have been a breakdown in the supervisory process.

16. How can or should we determine if the size of the insurance fund is sufficient and will continue to be sufficient to assure confidence and manage the costs of potential failures?

Without engaging in deception, no one can accurately foretell the funds that will eventually be required to assure confidence and manage the costs of potential failures. There are simply too

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many unknowns in the equation. Not only must one make assumptions as to such economic factors as future interest rates, real estate prices and default ratios, but one must make important assumptions about the managerial ability, negotiating skills and creativity of the FSLIC staff and the efficacy of the supervisory function.

It is my opinion that the confidence issue should be made moot by giving a clear signal to the public that the federal deposit insurance funds are indeed backed by the United States Government.

Those most closely associated with the potential problems facing the FSLIC should be able to provide a reasonable range of computer generated estimates of the funds required to resolve the known problems in any given economic environment. The computer program was developed and this procedure was followed with acceptable accuracy during the Pratt Administration.

Whatever the costs are, they must ultimately be paid. No matter how high or low the estimated cost is, the major focus of the FSLIC should be on how to reduce the number of problem cases and how to reduce the ultimate cost of resolving the problem cases that do arise.

17. You suggest "opening up the acquisition of financial institutions to well-capitalized responsible acquirers." How would you determine which potential acquirers are sufficiently "responsible?" Do you have concerns over breaking down the remaining barriers between banking and commerce? Are there many potential acquirers? Who? What would be the potential advantages to the acquirers?

In the real world of 1985, banking and commerce are so intertwined that the remaining "barriers" are merely "low hurdles" which provide exercise for the legal profession. I am indeed concerned over the potential for abuse that arises when any entity or person obtains control over an insured financial institution. Given the number of problems now existing, it is difficult to be too exclusive and philosophical about "whom we are going to let in."

Real capital at risk is a primary indicator of "responsible" in my view. I am not overly concerned if that capital comes from a savings and loan, commercial bank, insurance company, investment banker, auto company, manufacturing company or a lose affiliation of businessmen. Of course proven managerial capacity and business integrity are essential but difficult to accurately assess.

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There are as many potential acquirers as there are opportunities to make a profit. To the extent profits are viewed as a function of management and capital, there will be acquirers. If the potential for profits depends on the next move of the FHLBB, the number of acquirers will dwindle. The only way to approach a potential acquirer of a problem S&L is on the basis that the acquirer has a reasonable chance to make more money by taking the problem institution than by taking any other available opportunity in the investment universe.

18. In his testimony, Mr. Pratt suggested a shared cost method of deposit insurance which would create a percentage of deposit deductible which would be born by the depositor. What is your view of that proposal?

As with the other proposals that require certain depositor participation and/or risk, this proposal should be seriously considered in a time when there is a higher level of stability in the financial system. During the next several years when hundreds of banks and S&L's will be removed from the market place, we should not be implementing any program which will make this process more painful or risky than it already is.

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RESPONSE BY H. BRENT BEESLEY

TO QUESTION BY SENATOR WILLIAM PROXMIRE

According to the Bank Board, there are over 400 savings and loan associations that are insolvent under generally accepted accounting principles. These associations have combined assets of over $100 billion. It has been estimated that the loss to FSLIC would be at least $15 billion if these associations are liquidated. I would like each member of the panel to answer three questions:

1) If nothing is done for the time being, will the potential FSLIC loss get larger or smaller?

2) When should these insolvent institutions be closed?

3) How should the losses to FSLIC be covered?

The most important question facing the FSLIC and the Congress is how to minimize the costs facing the FSLIC. The answer to this question it to provide the FSLIC with the best professional management that money can buy.

Whether or not the cost to the FSLIC increases or decreases depends on two basic factors. The first factor is the cost of funds to the failed firm as compared to the opportunity cost of funds to the FSLIC. It may well be less costly to "warehouse" the assets of the failed firm with the firm's own deposits and overhead as opposed to carrying these assets inside the FSLIC or the Federal Assets Disposition Association. The second factor is how the assets are being managed inside the failed firm.

During the Pratt Administration at the FHLBB, there were many times when it was less costly to leave a failed firm open than to close it. This was the rationale for the "Pheonix Program."

Institutions should be closed at that point which minimizes the cost to the FSLIC. Ideally, a firm should be closed at the point when the market value of its assets is not less than the total of its liabilities coupled with the cost of administering the liquidation. If closures occurred at this point, there would be no loss to the FSLIC and no need for an insurance fund of any size.

Losses facing the FSLIC today should be covered by the payment of premiums by the savings and loan industry over a long period of time. Interim cash flow needs should be covered by debt. The new Federal Asset Disposition Association is one example of a very good vehicle to raise cash for the FSLIC. I have seen no evidence that would justify a large cash infusion for the FSLIC, and such an infusion would remove the present incentive for the FSLIC to find new and better ways of resolving its current problems.

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Shearson Lehman Mortgage Securities

Dear Mr. Chairman:

I am pleased to enclose my responses to your questions of September 25, 1985. As was the case with my testimony of July 25, 1985, these are my personal opinions, and do not necessarily represent the positions of Shearson Lehman Brothers or American Express.

Sincerely yours,

Andrew S. Carron
Vice President

Responses of Andrew S. Carron

1. What is your view of the National Council Task Force's proposal for risk-based net worth and a definitive time frame for an institution to come into compliance, or find a merger partner, or be placed in receivership?

Risk-based net worth is a variant of risk-sensitive insurance premiums, analogous to the use of deductibles in the private sector. Without commenting on the specifics of the National Council's plan, it should be noted that any plan to "tax" risk will have two effects that are opposite in their impact on risk-taking. On the one hand, the rate of return on risky investments is reduced relative to safe investments; economists call this the substitution effect, and it leads to less risk-taking, all other things being equal. On the other hand, the imposition of higher charges for the riskier investments reduces the overall profitability of the firm, leading to the adoption of a riskier stance to make up the higher costs; this is the income effect. Whether the substitution effect outweighs the income effect, and therefore is successful in reducing risk, depends on the size and structure of the insurance premiums or capital requirements. Risk-based net worth would be difficult to price and would potentially have adverse consequences. It is by no means obvious that any such system can reduce risk-taking by undercapitalized institutions.

Whatever decision is made with regard to net worth, institutions should be required to come into compliance during a relative short period of time. Merger or receivership proceedings should begin as soon as it can be determined that an institution will not be able to meet the new requirements.

2. With regard to the proposed asset management subsidiary, is the real advantage the ability to manage problem assets outside the ceiling of federal pay caps? Isn't a disadvantage that the value of such assets would decline if they had to be disposed of on a stand alone basis - as opposed to being in a package of good assets and solid customers to be sold as a going concern? What are the pros and cons of one asset management subsidiary versus twelve?

One advantage of the proposed asset management subsidiary is the ability to retain professional staff outside the ceiling of federal pay caps. (Another advantage is the ability to convert real assets into financial assets or cash.) Assuming the assets in question consist of nonperforming real estate owned, the value of the savings institution might well be enhanced by the removal of such assets. The presence of even a small proportion of real estate assets in an institution's portfolio can dissuade prospective purchasers. Unlike low-rate financial assets for which an active market exists (e.g. mortgages and mortgage-backed securities), real assets may be subject to wide variations in appraised value. There is no advantage to having twelve subsidiaries that cannot be achieved through one subsidiary with multiple regional offices; centralized control would seem to be desirable.

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3. If a substantial amount of the Home Loan Banks' assets consisted of loans to the FSLIC, could this severely lessen the willingness of the private sector to invest in a Home Loan Banks debt instrument? Why or why not? Currently what is the total excess debt capacity of the regional Home Loan Banks?

4. At what point would loans from the Home Loan Banks begin to impair the confidence of the private sector investors in the Home Loan Banks' debt obligations?

The prospect of increased borrowing by the Federal Home Loan Bank System to support the proposed asset management subsidiary has already increased the cost (spread over Treasury securities) of FHLBS consolidated obligations by 25 basis points. This translates into several hundred million dollars of additional interest payments per year once all such debt were refinanced. There is no specific point at which increasing leverage deters investors; rather it is a gradual process, whereby progressively higher yields are demanded as the capital position declines. The more fundamental question, of course, is whether it is appropriate to increase the amount of federally related debt outstanding by relying on FHLBS borrowings to fund the asset management subsidiary.

5. The primary supervision of thrifts has already been delegated to the local Federal Home Loan Banks. If the disposition of problem institutions were also delegated to the local banks, what would be left for the Bank Board? Wouldn't there be a danger of the Bank Board losing control?

The Bank Board would retain several important functions. These include the promulgation of regulations for federally chartered thrifts, control over FSLIC premiums and insurance regulations, direction of the Federal Home Loan Mortgage Corporation and Federal Home Loan Bank System, and general control over the examination and supervision process.

6. Should the FSLIC require its insureds to make a one percent deposit in the fund? Why or why not?

Given the FSLIC's urgent need for funds, an assessment should be considered a permanent contribution, despite its treatment as an asset for the FSLIC member. Any assessment or premium increase will further weaken the industry. It is an open question whether the benefits of increased FSLIC cash flow would offset the increased costs of failures in the industry.

7. If the FSLIC and the FDIC funds are not merged, where will the FSLIC obtain sufficient funds to deal with its problems over time?

The loss to the FSLIC for liquidating the 400-plus GAAP-insolvent thrifts will exceed $15 billion in present value. This is undoubtedly a conservative estimate of the total amount that will be required for current and future problem institutions. It is unreasonable to expect such amounts to come from the industry or the Federal Home Loan Bank System. Therefore, the only possible sources for such funds are direct appropriations or contributions by the Federal Reserve.

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8. With regard to other forms of market discipline by uninsured depositors and general creditors, it is argued that the market discipline is fickle, is trendy. Indeed, it is argued that a run is the ultimate form of market discipline. How do you respond to these concerns?

There is a fundamental dilemma in the attempt to maintain stability in the system while imposing discipline on the institutions. By putting large uninsured depositors at risk, the system will become less stable, because at the first sign of trouble those deposits will flow out. This imposes very rigid discipline, which is good, but also creates much instability, which is bad.

9. Should the FSLIC be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed bank with any profit after administrative costs arising from the transaction returned to the original stockholders?

10. If the burden of mismanagement was placed squarely and directly on the managers and stockholders, is it necessary to punish depositors and borrowers in order to achieve an improved supervisory system? If failures were handled through a purchase and assumption or forced merger at an earlier stage, regardless of size, wouldn't this dispose of the fairness question as it relates to large and small institutions?

Real capital is the primary bulwark against failure. Ideally, the FSLIC should intervene before the market value of the institution reaches zero. It could pay off creditors, estimate the remaining market value and pay off shareholders with those funds, and then liquidate or merge the institution. Any remaining funds could be paid to shareholders as available. The FSLIC may have the ability to do this under existing statutes.

11. In your opinion, what are the advantages and disadvantages of risk-based capital and risk-based premiums? Should we consider one or the other or both?

Please see the answer to question number 1.

12. There appears to be strong support for risk-based capital in some form. Some suggest an adoption of risk-based capital by the federal insurance agencies would give them the necessary authorities to regulate the activities of state-chartered institutions without granting the authority to override a state legislature. What is your view?

13. How would you recommend resolving the dilemma to the dual banking system created by states authorizing activities which place the federal insurance agencies at risk?

The separation of regulation and insurance inherent in the dual banking system has been a major factor in escalating the magnitude of thrift institution failures. Many state-chartered institutions have avoided federal efforts to impose stricter supervision, thus nullifying attempts to reign in the escalating costs of dealing with problem institutions. The increase in state powers has not been accompanied by a commensurate increase in supervision at the state level.

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14. Do you believe that the FHLBB and/or FSLIC needs increased enforcement authority? If so, in what areas?

The FHLBB requires the authority to deter activities that dissipate assets before the results of the activity are visible. This may require more power to issue cease-and-desist orders.

There is also a need for substantially more high quality supervisory personnel. Funds expended to pay higher salaries to larger numbers of examiners and supervisors would be recouped many times over through detection and prevention of excessive risk-taking.

15. Does the Community Savings and Loan and EPIC problem reinforce the need for certain activities to be engaged through a subsidiary of the holding company rather than a subsidiary of a depository institution?

All of the facts in the EPIC matter are not yet available. It would be premature to draw any policy conclusions at this time.

16. How can or should we determine if the size of the insurance fund is sufficient and will continue to be sufficient to assure confidence and manage the costs of potential failures?

The size of the insurance fund is not important to the maintainance of a deposit insurance system. If all problems were detected at an early stage, a very small fund would suffice. Absent detection, or under circumstances of an economy-wide crisis, a very large fund would be necessary to maintain confidence while keeping institutions open. The only requirement is that an alternative source of funds be available in the event that the insurance fund is depleted, and Congress has already indicated that this is the case through its resolution pledging the full support of the federal government.

17. In your testimony you state "Curtailing brokered deposits would force institutions to seek higher cost sources of funds." Both the FDIC and the FHLBB believe that the unfettered use of brokered deposits makes it more possible to attract high cost funds which leads to fast growth and high risk. In your view, how should the brokered deposit issue be handled?

Brokered deposits would appear to lack the attributes that contribute to institutional stability: They are short-term, easily withdrawn, and carry rates that readily adjust to changes in the risk structure. But these characteristics are common to all insured deposits, whether acquired over the counter, by mail or telephone, or through brokers. The problems are inherent in our system of deposit insurance, and in the combination of weak institutions and inadequate supervision.

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Questions from Senator Proxmire

According to the Bank Board, there are over 400 savings and loan associations that are insolvent under generally accepted accounting principles. These associations have combined assets of over $100 billion. It has been estimated that the loss to FSLIC would be at least $15 billion if these associations are liquidated. If nothing is done for the time being, will the potential FSLIC loss get larger or smaller? When should these insolvent institutions be closed? How should the losses to FSLIC be covered?

The potential loss will increase over time, even in present value terms, because institutions continue to enter into excessively risky ventures. These institutions should be closed as soon as possible. Please see the answer to question 9. The losses to FSLIC will have to be covered by appropriations or by contributions from the Federal Reserve. Please see the answer to question 7. It should be noted that the decision to close an institution does not depend on the immediate availability of funds. A problem institution can be closed, reorganized, and immediately reopened with new management retained from the outside by the FSLIC. This would stanch the rate of increase in costs, which is the most serious part of the problem.

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UNIVERSITY OF SOUTH CAROLINA
COLUMBIA, S.C. 29208

COLLEGE OF BUSINESS ADMINISTRATION

Response to Questions by Senator Proxmire Concerning Deposit Insurance Reform

by

Arthur E. Warner
Chair Professor
of Real Estate & Property Finance
The Francis M. Hipp Building

Introductory Observations - Recent improvement in the level of economic activity in the United States as indicated by recovery in real output (GNP) and continuing stability of prices and interest rates have alleviated much of the concern expressed in Senator Proxmire's preface to the three questions. As a result of these developments, interest rate spread in the thrift industry is running at about 280 basis points which is the most favorable it has been in several years. If these conditions continue, industry profits for 1985 should reach more than $5 billion after allowance for the special insurance assessment imposed by the Home Loan Bank Board. For these reasons, I am less apprehensive than Senator Proxmire that FSLIC is facing a loss of $15 billion in the near future.

(1) If nothing is done for the time being, will the potential FSLIC loss get larger or smaller?

My comments above indicate that, in my view, the amount of losses that FSLIC will incur in the next few months is declining. Recent congressional approval of the extension of the Net Worth Certificate program and the emergency thrift acquisition provisions of the Garn-St. Germain Act of 1982 embrace all that is necessary for Congress to do at this time.

(2) When should those insolvent institutions be closed? I doubt if anyone possesses the knowledge or omnipotence to answer this

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question. Accounting measures of insolvency are not the answer for they tend to overlook the good cash flow positions of a number of institutions that appear to be in trouble. I believe that each case, especially since the numbers are declining, should be examined individually to assess the quality of management, quality of assets and liabilities and the maturity spreads between assets and liabilities as well as other factors that can be identified by examination. The mechanism to do this is already in place; it should be given time to sort out the losers from the winners.

(3) How should the losses to FSLIC be covered? In addition to sources of funds now available to FSLIC, I believe that the creation of a liquidation corporation under Sec. 406 of the National Housing Act is a good idea. Chances for success of such an industry supported corporation are very good. Until this approach has had an opportunity to work, the Congress should refrain from taking any more drastic measures.

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DEPOSIT INSURANCE REFORM AND RELATED SUPERVISORY ISSUES

PART I

WEDNESDAY, JULY 31, 1985

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, D'Amato, Gorton, Mattingly, Hecht, Proxmire, Cranston, Riegle, Dodd, Dixon, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

Today the committee is holding its third hearing on the related subjects of institutional supervision and deposit insurance reform. Last week the committee heard from Chairman Isaac of the FDIC, and economists and analysts on required reforms in commercial banking insurance and supervision. That hearing was followed by one on Thursday which featured Chairman Gray of the Federal Home Loan Bank Board and two panels of former regulators and experts who each discussed thrift supervision and insurance.

Today, the committee will hear from representatives of the State legislatures and regulators and will also discuss the current and potential role for non-Federal deposit insurance. That is the primary focus of today's hearing.

Our first panel will include Representative Charles Evans of the North Carolina House of Representatives who is appearing on behalf of the National Conference of State Legislatures; Sidney Bailey, Virginia State Banking Commissioner, appearing on behalf of the Conference of State Bank Supervisors; and L.L. Bowman, commissioner of the Texas Saving & Loan Department, testifying on behalf of the National Association of State Savings & Loan Supervisors.

The second panel will consist of James C. Burns, Jr., executive vice president and treasurer of the Cooperative Central Bank in Boston; Donald R. Beason, president, Financial Institutions Assurance Corp., Raleigh, NC; Leonard Lapidus, executive vice president of the Mutual Savings Central Fund, Inc., of Woburn, MA; and Gene Artemenko, president of the United Airlines Employees Credit Union.

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The third panel will include Bert Ely, a well respected consultant from Alexandria; Chip Filson, senior partner in Callahan & Associates, and former Director of the Office of Programs at the National Credit Union Administration.

Several of you gentlemen have testified before the committee on previous occasions and for the benefit of everyone who has not we would request that you keep your oral presentations to not longer than 10 minutes. Shorter if possible. Your presentation will be followed by questions from members of the committee and, of course, your full written statements will be included in the record. We would expect to have additional questions for each of you for your response in writing after the hearing is over.

Senator Proxmire, do you have any opening remarks?

Senator PROXMIRE. No statement.

The CHAIRMAN. Gentlemen, do any of you have any opening statements?

Senator D'AMATO. Mr. Chairman, I have a statement that I would like to be included in the record as if read in its entirety.

The CHAIRMAN. Without objection.

STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Good morning, Mr. Chairman. Today's hearing will be the third in a series to examine Federal deposit insurance. Before we begin, I would just like to commend you on these timely hearings and welcome the panel of witnesses before us today.

While the Federal Deposit Insurance System remains stable, concern over the health of the system increases. The public is becoming increasingly concerned over whether or not the system can adequately handle an ever-changing banking and financial services market. It is for this reason that I find these hearings extremely appropriate at this time. I believe the time to review this system is now. Hearings such as these provide the proper forum to discuss matters of concern to the Federal deposit insurance industry.

This review, however, does not necessarily mean drastic change. In last week's hearing, Chairman Gray called for a move toward risk-related insurance premiums. A move such as this would be drastic.

As I emphasized in the hearing last week, determining the risk taken by a bank may be too difficult to accurately or promptly determine. Bank regulators should be more concerned with examining the management of imprudent banks, rather than attempting to levy higher premiums on what they perceive to be riskier activities.

I realize there are other issues to be discussed besides the idea of risk-related premiums, but an issue such as this is very important. Who is to decide what is riskier? At what risk level do we place a high-yield bond? Where are Fannie Maes on this scale? I just don't believe an adequate risk assessment can be made at this time without being, at least to a certain extent, very arbitrary.

It is my hope that these hearings will produce an increased awareness of the problems now facing the Federal Deposit Insur-

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ance System, and will provide us with the necessary information to develop responsible legislation to deal with these problems.

The banking industry is faced with more and more problems, including increased bank failures and bad loans to developing nations. These occurrences worry those concerned with the banking industry. There is a definite need to reassure a skeptical public that all is well.

It is my hope that this committee can accomplish these goals in this set of hearings. Thank you, Mr. Chairman.

The CHAIRMAN. May we invite the first panel to the table, Mr. Evans, Mr. Bailey, and Mr. Bowman. Mr. Evans, if you would like to begin, please.

STATEMENT OF CHARLES D. EVANS, CHAIRMAN, BANKS AND THRIFT INSTITUTIONS COMMITTEE, NORTH CAROLINA HOUSE OF REPRESENTATIVES, RALEIGH, NC; ON BEHALF OF THE NATIONAL CONFERENCE OF STATE LEGISLATURES

Mr. EVANS. Thank you, Mr. Chairman.

I would like to take this opportunity to thank you and the committee for allowing the National Conference of State Legislatures the opportunity to appear and present its position on matters before your committee. I am Representative Charles Evans, chairman of the banks and thrift institutions committee of the North Carolina House of Representatives. My home is Nags Head on the outer banks of North Carolina.

I appear before you today as a representative of the National Conference of State Legislatures and its committee on government operations and regulations which has jurisdiction over financial institutions issues.

The National Conference of State Legislatures [NCSL] is the official representative of the Nation's 7,461 State lawmakers. The organization provides basic issue research, technical assistance, comprehensive Federal budget and funding data, and training services for legislators and their staffs. Since its creation in 1975, the organization has also served as the Washington, DC, liaison for all State legislatures and has promoted policies developed through a State-Federal assembly.

NCSL AWARE OF CHANGING ENVIRONMENT

The National Conference of State Legislatures share the concerns which you, Mr. Chairman, and former and current Federal regulators have raised regarding the issue of deposit insurance. Policymakers among the States have addressed and continue to address the changing nature of financial institutions as we deal with the impacts of deregulation. State legislators are generally directing an increasing amount of attention to financial institutions as we deal with the changing environment that deregulation is producing. Simultaneously, we have witnessed, as you have, the growing numbers of thrift and commercial bank failures and have been compelled to respond to unforeseen effects of deregulation.

NCSL, on behalf of State legislatures, has kept apace with developments in both Federal and non-Federal insurance which can or do significantly affect consumer confidence and the integrity of fi-

nancial institutions generally. While State legislators are not as occupied with deposit insurance as we might be with education, public health, tax reduction, and public safety matters, I do feel that this subject is going to increase in the attention that is devoted to it and we would like to play a meaningful part in helping you to address concerns about the system and help to resolve any shortcomings that we may identify.

In attempting to resolve any difficulties with deposit insurance, NCSL feels that safety and soundness remain the foundation of any proposed policy changes. If any legislation is not likely to improve, or at least maintain, consumer confidence, then NCSL urges you and your colleagues to avoid it. Second, NCSL feels that both short- and long-term deposit insurance reforms are needed and these hearings that you have undertaken are an excellent step toward finding suitable and workable answers. Third, NCSL encourages you to strike a balance between open-ended deregulation and totally restrictive controls regarding institutional performance. Finally, deposit insurance reform should be used to strengthen the dual banking system in which our States strongly believe.

NCSL policy stipulates that Congress should examine closely a variable risk-related system for determining deposit insurance premiums. We feel the concept is certainly meritorious and one worthy of intensive scrutiny. Like so many other organizations and individuals who have testified before you, we are wary of how to ensure fairness and appropriateness among the criteria required to measure risk.

NCSL concurs with a finding of the task group on regulation of financial services which states that:

> The current deposit insurance system in effect forces prudently managed institutions to subsidize high-risk institutions through unrealistically low insurance premiums.

This came from the "Blueprint For Reform" as I stated.

While variable risk insurance may not overwhelmingly or substantially reduce risk taking, unless the premiums are extremely high, continuation of flat-rate assessments cannot serve to temper activities which potentially threaten individual institution soundness. There have been 510 thrift failures since 1980 and 63 commercial bank failures to date in 1985. Well-managed and well-supervised institutions are competing successfully in a deregulated financial environment. They are doing so while deposit insurance, particularly for thrifts, serves success and failure alike. There is no reason why the price for prudence ought to be maintaining and salvaging institutions that might be irresponsible or mismanaged.

In the short term, variable-risk premiums should be applied cautiously and in a limited fashion. NCSL feels that perhaps only some, for example, real estate development activities ought to fall under the initial risk-related umbrella. We certainly would urge that the U.S. Senate support a system which ultimately assesses institutional asset quality, portfolio management, and internal management experience, quality and stability. Individual institution assessment is the key to measuring the risk of specific activities. If this individual assessment does not occur, it would appear that

broad risk-related measurement tools might well be too constraining, unwarranted, and economically stifling.

Determining what is risky and decided on which criteria to base such determination do not appear to be a simple task nor does assessing additional premium charges for high risks present an easy task. Nevertheless, NCSL believes that a true test of the viability and validity of risk-based premiums cannot be achieved without tackling these tough questions. The answers provided in this first attempt to measure risk for deposit insurance premium purposes indeed might indicate the prospects for long-term application.

SURVEY SHOWS 434 THRIFTS ARE INSOLVENT

One key question which Congress must ask itself is: What should be done, if anything, regarding deposit insurance if risk-based premiums cannot be developed and implemented? FSLIC's and FDIC's reserves at present are approximately $6 billion and $18 billion respectively. In the former instance, as regards FSLIC, reserves are but a mere 0.61 percent of the total thrift industry assets, less than half of the average reserve balance over the past decade. A recently completed survey indicates that 434 thrifts are insolvent. That may indicate that the remaining approximately 2,700 thrifts are solvent, standing on less precarious groups, or beginning to restore balance to their assets and liabilities. Nonetheless, the report accurately demonstrates that FSLIC's need to deal with these faltering institutions is a major short-term problem.

The dynamics of deregulation, regardless of industry, does tend to weed out weaker, potentially less competitive entities. NCSL believes that Congress and State legislatures need to anticipate and plan for, to the extent possible, future failures. Risk-based premiums could reduce strains on deposit insurance reserves if applied in a timely fashion. They would certainly inject a sorely needed dose of fairness. If this Federal deposit insurance modification renders itself too cumbersome or complex, I believe you might also consider, as particularly concerns the FSLIC, the following:

One, additional supplemental premium assessments; two, borrowing from the FDIC; or three, increasing the flat-rate premium, although this does little for fairness and only serves to potentially ignore excessive risk taking.

NCSL believes that merging the two funds, FSLIC and FDIC, now would be premature. As long as public policy at the Federal and State levels differentiates between thrift and commercial bank activities, there will be some justification for two funds. It does appear, however, that we are on an evolutionary track and financial institutions are becoming less distinguishable. Merger is, therefore, something for which Congress, Federal and State regulators ought to plan.

Merger would resolve the current FSLIC reserve balance problem and reduce the threat of having to dip into the U.S. Treasury. Beyond that, NCSL sees little current merit in what would be, in our opinion, a poor public policy choice since it is not directly linked to safety or soundness.

In developing its deposit insurance policy, NCSL has been unable to devote ample time to at least three other alternatives which de-

serve indepth scrutiny. Over the next few months, NCSL's governments and regulations committee will be reviewing the following items:

One, risk-based capital standards; two, level of deposit insurance coverage; and three accounting alternatives.

As the organization makes progress in assessing these items and relating their potential implementation to financial institution safety and soundness, I will be glad to share our conclusions and data with the Senate Banking Committee.

Another course of action both suggested and partially implemented has been to give Federal regulators greater control over activities of State-chartered thrifts and banks. The nature of deposit insurance itself understandably commands Federal regulation to which members, whether they are State or federally chartered, must adhere. When regulation tends to take on preemptive airs and chips away at the dual banking system, then State legislators become wary.

State legislators recognize that development of a deregulated industry, management of faltering financial institutions, and addressing the changing nature of thrifts and banks compels applications of some constraints to ensure consumer confidence and to brake unnecessary risk taking. This is one explanation for NCSL's support for limited application of risk-based premiums.

However, NCSL has not supported FSLIC's direct investment rule and finds its current proposals to broaden its control over all investment activities of State-chartered thrifts as unwarranted.

The FSLIC proposals and activities tend to label States as only partially capable of regulating and monitoring financial institutions. These proposals also tend to ignore the capacities and performance of strong individual institutions, whether they are State or federally chartered, to responsibly handle a variety of activities on their own.

These regulatory maneuvers also circumvent the dual banking structure and foster a departure from State experimentation which has reaped public and private sector benefits. Yes, some States have granted their institutions powers beyond those permitted federally chartered institutions and, yes, some of them may not have worked well for certain institutions. Excessive regulatory controls, however, do not necessarily provide the answer to maintaining a healthy and viable financial institutions industry. To place general constraints on the future exercise of this authority in no way guarantees long-term benefits to any Federal deposit insurance system. They could also discourage participation in new activities and be financially stifling. We should encourage some flexibility in investment policy.

A more responsible plan, in NCSL's eyes, is to find an activity with which various institutions have had some or limited experience and include it as a supplemental premium cost item due to its high-risk qualities or potential. That seems to be a more satisfactory approach as long as individual institution strengths and shortcomings can be adequately assessed.

NCSL encourages both you, Mr. Chairman, and your colleagues on the committee to oppose mandatory Federal insurance for all financial institutions.

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While the marketplace may well eliminate the non-Federal deposit insurance option, there appears to be no merit in foreclosing private and/or State-sanctioned deposit insurance. North Carolina's Financial Institutions Assurance Corporation has served our State well. Its future, however, has not been brightened by the Ohio and Maryland situations and a reorganization is underway in our State as well.

OPTION OF STATE INSURANCE NEEDS TO BE RETAINED

Now, 25 private funds primarily serving thrifts and credit unions existed as of July of this year with the fate of Ohio's and Maryland's funds well known. While non-Federal insurance did not lead those two States' thrifts to insolvency, they were apparently inadequate to withstand the failure of their largest participants. It is obvious to NCSL that if State legislators wish to retain this option, they do need to ensure and periodically review these non-Federal deposit insurance resources for adequacy and stability. It is also imperative that private or State-sanctioned funds have backup resources as a reinsurance fund which may have to be implemented systemwide based on certain standards, or substantial backup capacity through lines of credit. This would improve State capabilities to deal with foundering institutions and to maintain public confidence as well. Having the Federal Government and its Treasury as the support resource is not the answer unless the activities of privately insured institutions are to be limited to those dictated by Federal deposit regulators.

We do not visualize non-Federal deposit insurance as the panacea for any Federal deposit insurance shortcomings or as a sole means for insuring deregulated financial institutions. However, we do see it as a worthwhile alternative which might be best tailored for the operation of certain types or sizes of financial institutions. And, NCSL strongly believes that Congress ought not preclude State legislatures from establishing State-sanctioned funds or using private funds which might match or exceed Federal deposit insurance standards.

I mentioned earlier that deposit insurance does not capture the same amount of State legislative attention as does education and other items, for example. Nonetheless, let me point out two examples of action taken in 1985. Nevada enacted legislation requiring all thrifts to be federally insured or privately insured, in the latter case whenever there is failure to qualify for Federal insurance accompanied by State administration approval. Texas established a savings and loan guaranty fund to support associations which are FSLIC insured.

Mr. Chairman and members of the committee, I want to thank you again for this opportunity for the National Conference of State Legislatures to present its comments and to participate in these hearings. I will gladly attempt to respond to any questions which you or other members of the committee may have and, more importantly, I will be happy to gather any additional information regarding our position on any of the items I've covered or on any particular subjects of interest to you or your committee. Thank you.

[The complete prepared statement follows:]

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Deputy Speaker
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State of Tennessee

Executive Director
Earl S. Mackey

STATEMENT BY

REPRESENTATIVE CHARLES EVANS
CHAIRMAN, HOUSE BANKS AND
THRIFT INSTITUTIONS COMMITTEE
NORTH CAROLINA HOUSE OF REPRESENTATIVES

ON BEHALF OF

THE NATIONAL CONFERENCE OF STATE LEGISLATURES

BEFORE THE

U.S. SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

JULY 31, 1985

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I am Representative Charles Evans, Chairman of the Banks and Thrift Institutions Committee of the North Carolina House of Representatives. I appear before you today as a representative of the National Conference of State Legislatures and its committee on Government Operations and Regulation which has jurisdiction over financial institutions issues.

The National Conference of State Legislatures (NCSL) is the official representative of the nation's 7,461 state lawmakers. The organization provides basic issue research, technical assistance, comprehensive federal budget and funding data and training services for legislators and their staffs. Since its creation in 1975, the organization has also served as the Washington, D.C. liaison for all state legislatures and has promoted policies developed through a state-federal assembly.

State legislatures share the concerns which you, Mr. Chairman, and former and current federal regulators have raised regarding deposit insurance. Policymakers among the states have addressed and continue to address the changing nature of financial institutions as we deal with the impact of deregulation. State legislators are generally directing an increasing amount of attention to financial institutions as we deal with the changing environment deregulation is producing.

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Simultaneously, we have witnessed, as you have, the growing numbers of thrift and commercial bank failures and have been compelled to respond to unforeseen effects of deregulation.

NCSL, on behalf of state legislatures, has kept apace with developments in both federal and non-federal insurance which significantly interrelate with retention of consumer confidence and the integrity of financial institutions generally. While state legislators are not as occupied with deposit insurance as they might be with education, public health and public safety matters, we do feel that our perception of deposit insurance needs might help accomplish meaningful changes and resolve any shortcomings.

In attempting to resolve any difficulties with deposit insurance, NCSL feels it is essential that safety and soundness remain the foundation of any proposed policy changes. If any legislation (or its components) is not likely to improve, or at least maintain, consumer confidence, then NCSL urges you and your colleagues to avoid it. Secondly, NCSL feels that both short- and longterm deposit insurance reforms are needed and these hearings you have undertaken are an excellent step toward finding suitable and workable answers. Thirdly, NCSL encourages you to strike a balance between open-ended deregulation and reasonable controls regarding institutional performance. Finally, deposit

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insurance reform should be used to strengthen the dual banking system.

Risk-Related Premiums

NCSL policy stipulates that Congress should examine closely a variable risk-related system for determining deposit insurance premiums. We feel the concept is certainly meritorious and one worthy of intensive scrutiny. Like so many other organizations and individuals who have testified before you, we are wary of how to ensure fairness and appropriateness among the criteria required to measure risk.

NCSL concurs with a finding of the Task Group On Regulation Of Financial Services which states that:

> "The current (deposit insurance) system in effect forces prudently managed institutions to subsidize high risk institutions through unrealistically low insurance premiums." (BLUEPRINT FOR REFORM, P.84)

While variable risk insurance may not overwhelmingly reduce risk-taking (unless premiums are high), continuation of flat rate assessments cannot serve to temper activities which potentially

threaten individual institution soundness. There have been 510 thrift failures since 1980 and 63 commerical bank failures to date in 1985. Well-managed and well-supervised institutions are competing successfully in a deregulated financial environment. They are doing so while deposit insurance, particularly for thrifts, serves success and failure alike. There is no reason why the price for prudence ought to be maintaining and salvaging institutions that might be irresponsible or mismanaged.

In the short-term, variable risk premiums should be applied cautiously and in a limited fashion. NCSL feels that perhaps only some real estate development activities ought to fall under the initial risk-related umbrella. We certainly would urge that the U.S. Senate support a system which ultimately assesses institutional asset quality, portfolio management and internal management stability. Individual institution assessment is key to measuring the risk of specific activities. If this individual assessment does not occur, it would appear that broad risk-related measurement tools might well be too constraining, unwarranted and economically stifling.

Determining what is risky based on which criteria does not appear to be a simple task nor does deciding on an additional premium charge for "high risks". Nevertheless, NCSL believes that a true test of the viability and validity of risk-based

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premiums cannot be achieved without tackling these tough questions. The answers provided in this first attempt to measure risk for deposit insurance premium purposes indeed might indicate the prospects for long-term application.

Alternatives to Risk-Related Premiums

One key question which Congress must ask itself is: "What should done, if anything, regarding deposit insurance if risk-based premiums cannot be developed and implemented?" FSLIC's and FDIC's reserves at present are approximately $6 and $18 billion respectively. In the former instance, reserves are but a mere .61 of total thrift industry assests, less than half of the average reserve balance over the past decade. A recently completed survey ("Insolvency and Risk-Taking in the thrift Industry: Implications For The Future", James Barth, et. al., July 4, 1985) indicates that 434 thrifts are insolvent. That may indicate that nearly 2700 are extremely solvent, standing on less precarious ground or beginning to restore balance to their assets and liabilities. Nonetheless, the report accurately demonstrates that FSLIC's need to deal with these faltering institutions is a major short-term problem.

The dyanamics of deregulation, regardless of industry, does

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tend to weed out weaker, potentially less competitive entities. NCSL believes that Congress and state legislatures need to anticipate and plan for, to the extent possible, future failures. Risk-based premiums could reduce strains on deposit insurance reserves if applied in a timely fashion. They would certainly inject a sorelyneeded dose of fairness. If this federal deposit insurance modification renders itself too cumbersome or complex, I believe you might also consider (for FSLIC particularly):

A) Additional supplemental premium assessments; B) Borrowing from FDIC (which, at this time, appears more stable); or C) Increasing the flat-rate premium (although this does little for fairness and only serves to potentially ignore excessive risk-taking).

Merger of FDIC and FSLIC

NCSL believes that merging the two funds now would be premature. As long as public policy at the federal and state levels differentiates between thrift and commercial bank activities, there will be some justification for two funds. It does appear, however, that we are on an evolutionary track and financial institutions are becoming less distinguishable. Merger

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is, therefore, something for which Congress, federal and state regulators ought to plan.

Merger would resolve the current FSLIC reserve balance problem and reduce the threat of having to dip into the U.S. Treasury. Beyond that, NCSL sees little current merit in what would be a poor public policy choice since it is not directly linked to safety or soundness.

Other Options

In developing its deposit insurance policy, NCSL has been unable to devote ample time to at least three other alternatives which deserve in-depth scrutiny. Over the next few months, NCSL's Government Operations and Regulation Committee will be reviewing:

A) Risk-based capital standards;
B) Level of deposit insurance coverage; and
C) Accounting alternatives, such as GAAP.

As the organization makes progress in assessing these items and relating their potential implementation to financial institution safety and soundness, I will be glad to share our

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conclusions and data with the Senate Banking Committee.

Federal Regulation

Another course of action both suggested and partially implemented has been to give federal regulators greater control over activities of state-chartered thrifts and banks. The nature of deposit insurance itself understandably commands federal regulation to which members, whether they are state-or federally chartered, must adhere. When regulation tends to take on preemptive airs and chips away at the dual banking system, then state legislators become wary.

State legislators recognize that development of a deregulated industry, management of faltering financial institutions, and addressing the changing nature of thrifts and banks compels application of some constraints to ensure consumer confidence and to brake unnecessary risk-taking. This is one explanation for NCSL's support for limited application of risk-based premiums.

However, NCSL has not supported FSLIC's direct investment rule and finds its current proposals to broaden its control over

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all investment activities of state-chartered thrifts as unwarranted.

The FSLIC proposals and activities tend to label states as only partially capable of regulating and monitoring financial institutions. These proposals also tend to ignore the capacities and performance of strong individual institutions (state-or-federally chartered) to responsibly handle a variety of activities.

These regulatory maneuvers also circumvent the dual banking structure and foster a departure from state experimentation which has reaped public and private sector benefits. Yes, some states have granted their institutions powers beyond those permitted federally-chartered institutions and, yes, some of them may not have worked well for certain institutions. Excessive regulatory controls, however, do not necessarily provide the answer to maintaining a healthy and viable financial institutions industry. To place general constraints on the future exercise of this authority in no way guarantees long-term benefits to any federal deposit insurance system. They could also discourage participation in new activities and be financially stifling.

A more responsible plan, in NCSL's eyes, is to find an activity (or activities) with which various institutions have had

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some or limited experience and include it as a supplemental premium cost item due to its "high risk" qualities or potential. That seems to be a more satisfactory approach as long as individual institution strengths and shortcomings can be adequately assessed.

Non-Federal Deposit Insurance

NCSL encourages both you, Mr. Chairman, and your colleagues to oppose mandatory federal insurance for all financial institutions.

While the marketplace may well eliminate the non-federal deposit insurance option, there appears to be no merit in foreclosing private and/or statesanctioned deposit insurance. North Carolina's Financial Institutions Assurance Corporation (FIAC) has served our state well. Its future, however, has not been brightened by the Ohio and Maryland situations.

Twenty-five "private" funds serving thrifts and credit unions primarily existed as of July, 1985 with the fate of Ohio's and Maryland's funds well known. While non-federal insurance did not lead those two states' thrifts to insolvency, they were apparently inadequate to withstand the failure of their largest

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particpants. It is obvious to NCSL that if state legislators wish to retain this option, they do need to ensure and periodically review these nonfederal deposit insurance resources for adequacy and stability. It is also imperative that private or state-sanctioned funds have back-up resources (as a reinsurance fund). This would improve state capabilities to deal with foundering institutions and maintain public confidence. Having the federal government and its treasury as the support resource is not the answer unless the activities of institutions privately-insured were limited to those dictated by federal deposit regulators.

We do not visualize non-federal deposit insurance as the panacea for any federal deposit insurance shortcomings or as a sole means for insuring deregulated financial institutions. However, we do see it as a worthwhile alternative which might be best tailored for the operation of certain types or sizes of financial institutions. And, NCSL strongly believes that Congress ought not preclude state legislatures from establishing state-sanctioned funds or using private funds which might match or exceed federal deposit insurance standards.

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State Actions in 1985

I mentioned earlier that deposit insurance does not capture the same amount of state legislative attention as does education, for example. Nonetheless, let me point out two examples of action taken in 1985. Nevada enacted legislation (S.147) requiring all thrifts to be federally-insured or private-insured (in the latter case whenever there is failure to qualify for federal insurance accompanied by state administration approval). Texas established a savings and loan guaranty fund (SB 497) to support associations which are FSLIC insured.

Mr. Chairman, I want to thank you for extending this opportunity to NCSL to participate in these hearings and I will gladly respond to any questions which you and other members of the committee might have.

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The CHAIRMAN. Thank you very much, Representative Evans. Commissioner Bailey.

STATEMENT OF SIDNEY A. BAILEY, COMMISSIONER OF FINANCIAL INSTITUTIONS FOR THE COMMONWEALTH OF VIRGINIA; ON BEHALF OF THE CONFERENCE OF STATE BANK SUPERVISORS

Mr. Chairman, members of the Committee, I am Sidney A. Bailey, Commissioner of Financial Institutions for the Commonwealth of Virginia and Past-President of the Conference of Sate Bank Supervisors, on whose behalf I am testifying today.

The Conference of State Bank Supervisors (CSBS) is the professional organization of state officials who charter, regulate and supervise the approximately 10,500 state-chartered commercial and savings banks of the nation. Created in the early 20th Century as a clearing house for the ideas of the state bank supervisors on common problems, CSBS has evolved into the major champion of our decentralized American banking and bank regulatory structures. In addition, the Conference has become the most significant single source of educational and research services aimed at strengthening individual state banking departments.

We are pleased to have this opportunity to testify before this Committee and address the roles of the primary regulators of banks, the Office of the Comptroller of the Currency (OCC) and the respective state banking departments, and the Federal Deposit Insurance Corporation, within our dual banking system.

BACKGROUND

Our unique American dual banking system was created in 1863. Congress, responding to problems encountered in financing the Civil War effort, enacted the National Currency Act -- later replaced by the National Bank Act of 1864 -- to authorize a system of federally-chartered, but privately-owned national banks which would issue a new national paper currency. From 1863 through 1913, state and national banks followed separate regula-

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tory tracks, although state law in several areas was equally applicable to both state and national banks. Conceptually, the system was simple and logical; the chartering agency was the regulator of the institutions it chartered.

In 1913, passage of the Federal Reserve Act, which was designed to provide an effective means of controlling the monetary system, constituted the first significant overlay of federal law on state banks. Twenty years later, the second significant overlay occurred with the creation of federal deposit insurance.

The Federal Deposit Insurance Corporation was created by the Banking Act of 1933 to protect depositors in the nation's banking system, and to promote the stability of the banking system through safe and sound banking practices. The Corporation accomplishes these purposes through a program of Federal deposit insurance and through its role as the secondary, limited-scope regulator, of the more than 8,000 FDIC-insured State-chartered banks that are not members of the Federal Reserve System.

As you are aware, the American commercial banking system is remarkably diverse. There are nearly 15,000 commercial banks, which range in size from multi-billion dollar institutions serving international markets to small community banks serving primarily their own towns and neighborhoods. Of those 15,000 banks, over 10,000 are chartered, examined, supervised and regulated by state banking authorities, with the remainder chartered by the Comptroller of the Currency.

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Each state bank department is charged with a broad public interest responsibility toward the entire community served by the banks the agency regulates. This responsibility is shared by the Office of the Comptroller of the Currency (OCC) as the regulator of national banks. As primary regulators, the states and the OCC have a continuing, significant interest in the effects generated by the sale or closing of troubled institutions.

In the context of today's hearing a few comments about the state role, as the primary regulator of state-chartered institutions, are in order.

First, the chartering authorities have a broad interest in the safety, soundness and integrity of the financial institutions of the communities in their states.

Second, state supervisory knowledge of the community is a valuable resource, and combined with the broad responsibilities of the primary regulator, this knowledge can help state regulators play an important role in legislatively-designed solutions.

Third, the quality of state bank regulation is high and bank regulators are striving to improve both people and procedures.

Fourth, suggestions as to regulatory restructuring which would lead to an increased ability on the part of federal agencies to focus their attention on problem areas are meritorious.

The role of the primary regulator is to ensure laws and regulations as to safety and soundness are carried out, in the interest of the public who have a right to a stable and sound

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financial system. The majority of bank failures have historically been attributed to fraud, improper loans to bank-related individuals and managerial weakness. These matters are the responsibility of the primary regulator. In current failures it is possible to discover some of all these elements. However, in the case of widespread institutional failures, the state of the economy and economic policy can be seen as a major contributing factor. Macroeconomic variables cannot, for the most part, be overcome by a regulatory presence.

In the past two years the number of bank failures has reached post-depression records. Last year's 79 bank failures may be matched again this year or even surpassed, based on the 52 failures which have occurred in the first six months of this year. These failures suggest a system under excessive strain. The total of 79 failures during last year is greater than the 67 institutions which failed for the entire period of 1960-1974.

This situation has brought the role of the FDIC to the forefront. As the Federal insuror of deposits, it must concern itself with both the decline in public confidence in our financial institutions and the need to preserve the assets of the insurance fund. The FDIC has done well in fulfilling its statutory responsibility during these difficult times.

It must be remembered, however, that the role of the FDIC is limited by its charter and that role does not encompass the full breadth of public interest concerns embodied in our system of bank regulation. The FDIC is, in essence, a secondary, limited-

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scope agency. Broad expansion of the authority of the insuror, at the expense of the authority of the primary regulator, would be an overreaction to the current situation. Rather, cooperation between regulatory agencies and flexibility in handling problem situations should be stressed.

FAILING BANKS

The closing of a bank constitutes essentially the revocation of the bank charter granted by either the Comptroller of the Currency or the respective state. Therefore, it has always been the responsibility of the primary regulator to determine both the appropriate time for a bank to be closed and the circumstances thereof. Obviously, there are implications for the insuror of the institution in both the timing and the way in which the closing is handled. Therefore, as in most areas of modern bank regulation, a great deal of cooperation is required between the primary bank regulator and the FDIC.

Most state statutes provide a rather specific description of the conditions that would require the respective Supervisor to close the bank. For all practical purposes the state is bound by those requirements. It works to the benefit of the public, as well as the agencies involved, that there be close cooperation between state and federal authorities when a failing bank situation is at hand. The states and the FDIC have been diligent in ensuing that this essential level of cooperation has been maintained.

State bank supervisors exercise a degree of judgemental

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discretion in dealing with institutions that are on a course leading to failure. Every effort is made to restore problem institutions to a healthy status and maintain their service to the community. There is a point, however, where the primary regulator can determine that the erosion of equity capital will continue unabated and that termination of the charter by the chartering authority is the least undesirable of existing options. At this point, the infusion of additional funds either as an advance from the FDIC or from private sources as capital would simply prolong the death rather than restore the institution to health.

Once it becomes apparent that an institution must be closed, the timeliness of actions and selection of procedures to be followed is critical in bringing about a favorable resolution of the situation. Whether we are dealing with a critically wounded institution or a closed one, the disposition should take the form that is least disruptive, most efficient, and least costly. Since each failure situation presents a new set of particularized circumstances, each with its own problems, it is not possible to have a general rule as to the appropriate way to manage a failure. It must be remembered that merger, purchase and assumption, conservatorship, and liquidation are merely tools, the choice of which depends on the likelihood that each will fashion the desired end in a particular set of circumstances. It is important that the respective interests of all segments of the public be considered. We believe it preferable to tailor a

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prescription to meet the specific situation with the primary regulator taking the lead, not the FDIC as insuror. The primary regulator, as a rule, has a broader perspective and a closer knowledge of the individual situation.

Cooperation and flexibility are the two key elements in handling a bank failure. With the primary regulator working closely with the insuror of the critically wounded institution, the combined expertise, resources and regulatory tools of the state and federal systems can be brought into play. Experience has shown that an efficient and minimum disruptive solution can be accomplished at a relatively low cost loss to the FDIC fund. In some cases, the regulatory tool selected to meet broader objectives may not represent the lowest projected cost. Historically, however, there has not been a wide spread between the actual loss figures for the various tools. Given the purposes for which the FDIC fund was established, it is often appropriate for the fund to absorb an incremental additional cost in order to maintain services in a trade area, public confidence in financial institutions and stability in the banking system.

State supervisors have flexibility in handling bank failure situations on a case-by-case basis. Merger partners can be sought out in advance of actual closing. Procedural requirements can be waived. Assets and liabilities may be split and sold off piecemeal. In point of fact, the purchase and assumption transaction is the preferred solution in most cases. Most states allow the bank supervisor to arrange a voluntary supervisory

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merger prior to book insolvency, while a few allow the supervisor to require such a merger.

CSBS would oppose attempts to amend section 116 of the Garn-St. Germain Depository Institutions Act of 1982 to allow the FDIC to arrange the sale of the assets of a "failing" bank rather than a bank which has been closed. First, such an amendment is unnecessary. State laws and regulations have provided adequate flexibility to arrange such transactions and, in several cases, have been specifically amended to accomodate the interests of the FDIC in handling failing banks. It must be remembered that the interest of the state in fashioning a timely and suitable remedy to a problem situation is at least as great as that of the FDIC, if not more so. Second, allowing the FDIC to, in essence, close a bank would be a severe breach of our system of bank chartering and regulation. It is the primary regulator, which grants the charter and is responsible to the public for performance under that charter, which ultimately bears the responsibilty for the revocation of that charter and the closing of that institution. It is the primary regulator who is in the best position to pass judgement on the soundness of an institution, its potential for survival and its importance to the community. Third, allowing the insuror to close an institution may well lead to closing institutions for the wrong reason: protection of the insurance fund. Often, the earlier a problem institution is closed or merged, the smaller the loss to the fund. Broader public interests, however, are served by our system of bank regulation

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and entrusted to the primary regulators of banks. These other objectives, including the rehabilitation of institutions, may well be forgotten by an agency with limited scope. There would obviously be great potential for the abuse of discretion in the determination of what is a "failing" institution or when such authority should be invoked.

The bottom line in the handling of any bank failure situation is the maintenance of banking services and public confidence in a stable banking system. Surviving institutions should be able to operate in an environment that has been distrupted to the minimum extent possible and the public should be able to continue receiving loans and deposit services with minimum inconvenience and added cost. The FDIC fund was created to protect depositors and to promote the stability of the banking system. Banks have contributed to the fund for these purposes. Protection of the fund, in and of itself, is not the primary goal of a failing bank exercise. An incremental cost to the fund, incurred to serve the broader policy objectives set by Congress, is often appropriate and best serves the public interest.

IMPROVED SUPERVISORY TECHNIQUES

State banking departments are constantly improving the assessment techniques used in determining the conditions of financial institutions. They are taking the initiative in developing necessary analytical tools, improving on personnel skills, and building lines of communication with other concerned agencies.

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Many state banking departments have developed their own data processing systems. This has greatly enhanced their ability to analyze data gathered from state sources as well as that supplied by the federal agencies. In fact, some have integrated data from Uniform Bank Performance Report with state Bank Examination Reports and Reports of Condition, thereby significantly improving the availibility and content of the information. This is particulary helpful in troubled bank situations.

A good example of state innovation may be found in Nebraska, which recently introduced a self-examination program in which 104 state-chartered banks have agreed to voluntarily participate. The state is asking these institutions to submit monthly reports on data pertaining to their asset and liability management procedures and any delinquent loans on their books. Within ten days, the banking department will key in these reports and print out peer group information and return this data for the bank's own analysis of its financial condition in relation to other Nebraska state banks. This procedure will enable the banking department to track, in a more timely manner, these particular elements which can adversely effect a bank's financial stability on short notice.

Both federal and state bank regulators continuously review and revise as necessary existing plans for monitoring the financial condition of banks under their respective jurisdiction. Financial analytical technology is evolving slowly but satisfactorily in view of the current state of the art. However,

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with the everpresent changes in market onditions and economic developments which reflect on our industry, it is not clear that we will ever be able to consistantly and accurately predict the future financial condition of every bank.

States are responding to increasing concern over the condition of the industry through actions such as responsible regulatory initiatives for state authorized bank powers; expanded education programs for examination personnel; and accreditation of state banking departments.

First, the states have approached the regulation of state authorized bank activities/powers in a very responsible manner. Historically, the granting of powers to state-chartered banks is a proper and traditional exercise of the state. States that have allowed expanded bank powers (additional to those authorized under the federal Bank Holding Company Act) have experienced no widespread report of harm to the safety and soundness of practicing banks. In fact, banks implementing subject powers have generally benefited through increased revenues and strengthened capital positions, and the public has been served well without undue harm from tie-in practices or other conflicts of interest.

During the last year, several states have acted to increase state bank investment powers through statutory initiatives. Generally, language in these legislative efforts contain some type of restriction on investments (caps on percentage of investment, requirement to invest through subsidiary, CRA

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requirements, and others). California and New York, as examples, have drafted solid, comprehensive regulations to go along with the increased investment powers.

In California, a commission of industry and state representatives was established to develop guidelines for regulating the new securities investment limits. It was a case of clear and decisive action on the part of the state banking department to include representatives from the regulated banking industry in drafting responsible regulations to govern a broad legislative grant of authority. The resulting regulation covered definitions, restrictions and requirements for authorization and approval procedures.

The New York Banking Board adopted a regulation on real estate equity investment for its state-chartered banks which places strict limitations upon the exercise of those powers in recognition of the safety and soundness issue that might surround the new powers. The regulation limits to 5 percent the maximum percentage of a bank's assets which may be invested in real estate equity, including loans made to real estate projects. It also requires that a certain percentage of the amount invested in real estate equity be invested in "qualifying community investments".

These are only examples. Other states that have recently enacted enabling powers legislation are carefully monitoring bank activities in these areas to determine if additional regulatory guidelines will be required to ensure the safety and soundness of

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participating institutions. The point is, that states which elect to expand bank powers and allow some increase in the mixing of banking and commerce have done so responsibly and have increased their regulatory efforts.

CSBS would strongly oppose the expansion of FDIC authority over the activites of banks at the expense of the authority of the primary regulators. CSBS believes that the federal agencies should not be permitted to set aggregate and individual limits on approved activites.

THE CSBS EDUCATION PROGRAM FOR STATE BANK EXAMINERS

A basic goal of CSBS is to help states meet their educational needs in order to improve the quality of bank supervision. The benefits of this program accrue to banking departments, the banking community and the public at-large. As early as 1964, CSBS, then known as the National Association of Supervisors of State Banks, held it first annual school for state bank examining personnel. In 1972, CSBS joined with the FDIC in order to offer state banking department personnel additional training.

Educational requirements and needs of the banking departments have undergone unprecedented growth during the past 10 years. Increased enrollment and expenditures in CSBS programs from 1977 to the present provide dynamic proof of this growth. For example, the CSBS allocation to educate and train 239 state banking department personnel in 1977 was $164,068. By 1984, training expenditures almost tripled to $451,309, and supported approximately 740 individuals. Over 800 state banking department

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personnel will attend ten different programs, repeated throughout the nation, in 1985. CSBS has recognized that if the training needs of state banking department personnel are to be met, the Conference must continue to expand its commitment of time and financial resources to education and training.

Changes in the structure of financial institutions have a significant impact upon bank regulation, supervision and examination. New and modified procedures are needed to respond to new banking services, new ways of providing those services, and new operational structures for financial institutions. CSBS has responded to this surge in training needs with an increased commitment to our education program.

In turn, CSBS has chosen to respond to the challenge of an increasing educational committment by establishing the Education Foundation of the State Bank Supervisors. Creation of the Foundation will ensure quality training for state banking department personnel and the type of effective supervision and comprehensive examinations that the banking community requires and deserves. The Foundation offers a wide range of educational opportunities as well as a Scholarship Assistance Program to worthy applicants. Some of the programs are as follows.

School for Beginning Examiners. This school meets the need for technical education and training of beginning bank examiners, to supplement on-the-job training during an individual's first year of employment.

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Intermediate School for Bank Examiners. Designed as a credit evaluation school, this program provides additional education to examiners who are beginning to work with installment, mortgage and small commercial loans.

Advanced School for Bank Examiners. This program is intended for examiners who have assumed supervisory responsibilities for the examination of various size banks. The school helps these examiners plan, manage, coordinate and implement the entire examination function.

School for Senior Personnel. Held annually at the University of Oklahoma, this school is designed to help experienced bank supervisory personnel make the transition from largely technical duties to the management of a broader range of problems and concerns faced by state banking departments.

Seminars for Deputy Supervisors. These annual regional seminars are designed to help both deputy supervisors and other senior management personnel to address current issues and problems that directly concern the banking system in general and state banking departments in particular.

EDP Examiner Training Program. Multi-level training for state banking department personnel in two expanding, extremely

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complex, yet vital areas of financial institutions regulation -- the use of the computer in the supervisory process and the effective oversight of institutional computer operations.

Seminar for State Banking Department Attorneys. This biennial seminar brings together state banking department attorneys, assistant attorneys general assigned to banking departments and state bankers association legal counsels. The program reviews litigative, legislative and regulatory developments that impact the banking structure and bank regulatory authority of the states.

Seminars on International Banking. Emphasis of this program is on the supervisory and regulatory activity involving international lending and related transactions by domestic banks, and the chartering and supervision of foreign-owned banking facilities in the United States.

Seminars on Interstate Banking. The dynamic of interstate banking is one of constant change and variation. Defining the role of state supervision as these variations occur is essential to the development of effective control and planned growth of this enterprise.

Bank Holding Company Examination Training. The program works to eliminate duplicate regulatory burdens while assuring

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the safety and soundness of bank holding companies as entities, and maintaining state determination of banking structure.

Graduate Education Scholarships. The Foundation provides three new scholarships annually for outstanding individuals to attend a graduate school of banking of their choice. Since all of these schools have three-year curricula, the Foundation has nine scholarship recipients involved in this program each year.

Tuition Support to FDIC Examiner Training Programs. The Foundation joins with the FDIC and states in co-sponsoring attendance by state bank supervisory personnel at specialized schools that focus on particular aspects of examination. Tuition grants help defray transportation, tuition, room and board, and training materials costs.

Methods of Instruction Course. In recognition of the fact that quality instructors are essential to the success of any educational endeavor, a "teach-the-teacher" session is held annually for faculty members of all Foundation-sponsored courses The goal of this program is to update faculty on instruction. The curriculum emphasizes the use of visual aides, classroom participation methods, and procedures for handling a variety of classroom situations.

In addition, Foundation educational specialists have concentrated their attention and efforts on the highly technical

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tasks of curriculum development and the creation of new programs to help state banking departments maintain their educational proficiency in a number of new areas, particularly: International Banking, Interstate Banking and Advanced Banking Technology.

THE CSBS ACCREDITATION PROGRAM

Any effort to improve the quality of bank regulation must be firmly grounded in efforts to maintain and improve the quality of the regulatory agencies themselves, in our case, the state banking departments. Current developments in the industry underscore the need for competently staffed and well-run safety and soundness oriented regulatory programs. The majority of state banking departments are as well, or better equipped to charter and supervise their institutions than are their federal counterparts.

CSBS has developed two voluntary programs -- Department Self-Evaluation and State Banking Department Accreditation -- designed to help state regulators preserve the current dual banking system and meet their own, diverse professional and managerial needs. The goals of these programs are to strengthen state banking department capabilities to assure the safety and soundness of banking within each respective state, and to achieve recognition of the high level of capability within the state bank regulatory system.

States considering accreditation first evaluate themselves, using the Self-Evaluation Guide which is contained in the program guide. The approximately 100 criteria of the Self- Evaluation

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Guide provide a department with a list of those items that other regulators consider essential in maintaining a superior department. If deficiencies in the department are discovered, the Self-Evaluation should produce a standard against which improvement may be measured. When the department has removed its shortcomings, if any, it may decide to request accreditation.

Accreditation entails forwarding to CSBS a completed self-evaluation, together with appropriate narrative and documentary materials. This material is reviewed by a panel of distinguished regulators who then visit the department and perform their own evaluation. The report of this visitation team is reviewed by a second, audit panel to ensure consistency from state to state, and act as a quality control mechanism. If recommendations are favorable, the decision is made by CSBS to accredit for a five year period, subject to annual review and renewal.

No federal agency undergoes a comparable, rigorous standards review. CSBS believes that once a state has completed this review and has been accredited, federal agencies should accept the examination reports and findings of that state unless the agency can show cause why it should not. In essence, the burden of proof of the quality of state supervision would be shifted from the state to the federal agency in accredited states. Of course, the FDIC would continue its presence in the examination and supervision of state-chartered problem banks to the same extent it had such a presence in national banks. It is of note

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that, in developing its review programs, CSBS invited participation by the federal agencies. That door remains open.

To the extent that Congress may feel that a federal agency should pass judgement on the state accreditation program CSBS believes that the responsible federal agency should be one which has no vested interest in the outcome. For example, under the Bush Task Force proposal, there is an apparent conflict of interest in having the FRB pass judgement on the quality of a state banking department, where approval would mean a withdrawal of the FRB from examination and supervision of Bank Holding Companies in that state. This conflict does not appear to exist with the FDIC, under the Bush Task Force proposal, so long as it is able to maintain a presence in troubled institutions. Of course, in principle, we see no reason or need for federal agencies to pass independent judgement on the quality of states bank departments which have been accredited.

FRANCHISE VALUE OF BANKS

CSBS believes that it is in the public interest to protect the franchise value of the bank charter. The value of a franchise bears a direct relationship to a market sector's tolerance for regulation. Congress must act to stem the tide of corporations which are not banks or bank holding companies, but which do own and operate banks or are otherwise offering bank-like services. If you do not, the franchise value of banking will be so diminished that no business man in his right mind would put up with the level of public interest regulation imposed on banks.

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The erosion of the traditional private provinces of banking -- of the uniqueness of banking -- is far more serious than mere inter-industry squabbles.

That a direct relationship exists between expanded bank powers and increased public interest regulation is clear. What is not clear, is where the balance between competition and regulation must be struck. Bank supervisors are not so sanguine, as some federal regulators, that rapid expansion of powers and increased regulation is the only correct prescription. We support some expansion of bank powers consistent with the principles of safety and soundness and separation of banking and commerce; we also would be happy to participate with you in removing inefficient, wasteful and burdensome regulatory activity mandated by statutory excesses. CSBS believes both that the franchise value of the bank charter should be protected and enhanced, and that our system of financial intermediation must remain decentralized and firmly in the private sector.

RISK BASED PREMIUM

The concept of a risk related premium for deposit insurance has a significant initial appeal. It seems to make good sense that an institution that is behaving in a risky or an extraordinarily aggressive manner should pay a higher premium for insurance coverage than other institutions. In recent months, the exercise of investment powers beyond the traditional scope of banking and overly aggressive use of brokered funds have been suggested as evidence of greater risk for an institution.

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Institutions that give the appearance of running lower risks by tending to their knitting, so to speak, and serving their local communities should probably incur lower premium costs.

However, recent history has shown that even the most conservatively run institution can fall into the trap of adverse economic conditions such as volatile interest rates, declines in commodity prices, and declining real estate values. Although, many of these adverse conditions are the reflection of fiscal and monetary policies, individual institutions are now suffering an adverse fate. The point is that the risk of doing the business of banking has increased for those confined to traditional activities as well as for those who have expanded their range of services. Of course, the federal safety net sits under all of these institutions to some degree or another, with an increasingly open admission that some very large banks are fail-safe because their failure would severly harm the entire international financial system.

Thus, the two major problems associated with a risk based deposit insurance premium are determining the appropriate measure of risk for various activities of the institution, including the question of who should make this determination, and determining the difference in premium charge sufficient to produce the desired effect. Presumably, a higher premium should make the management an institution think twice before commencing a rated activity or conversely, should cover the cost of greater losses to the insurance fund resulting from institutions engaging in

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such activities. An initial determination must be made whether premiums should be set on a group rate basis, like medical insurance, or on a scale of groupings based on common characteristics, or simply on a bank-by-bank analysis. Given that CSBS does not believe that the skills and technology are available today to predict far in advance which institutions will fail, the ability to develop a risk related premium is weakened. Bank supervision is closer to an art requiring skills and judgment than it is to a science relying on quantifiable measures with lead times adequate to predict failures. This leads to the conclusion that the blanket assessment of risk would be essentially arbitrary and that risk assessment might have to be done on a bank-by-bank basis. In assessing risk, it must be determined whether more exposure to loss would result from an institution standing pat or from engaging in a wider range of activities.

Assigning a flat risk rating to a given activity would lead to gross inaccuracies. Each activity will vary in its risk factor, depending on variables such as location, capital or managerial skill. An activity which is risky in California may be perfectly safe and profitable in Virginia. In point of fact, an activity which is risky in Blacksburg, Virginia, may be perfectly safe and profitable in Alexandria, Virginia. Moreover, an activity which is risky in Alexandria if performed by Banker X may be perfectly safe and profitable in Alexandria if performed by Banker A. Risk assessment requires a knowledge of the

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activity, the market and the people involved. The extent to which a federal regulator or a state regulator, an insuror or a primary regulator, can best make those judgements is a critical question in setting up a system of risk assessment.

Risk should be associated with what an individual institution is doing in a specific market and should take into consideration the institution's performance record. This case-by-case assessment would not lend itself to generalized formulae. Rather, the determination of a risk premium should be the responsibility of the primary regulator, which has the ability to delve into the specifics of an individual case to assemble and analyze the relevant information.

The phenomenon of the "fail-safe" bank creates another problem for a risk-based system. Since, by definition, there is no chance of failure in a "fail-safe" institution, the risk-related premium for these 25 to 100 large institutions would approach zero. Therefore, either the activities of these extremely large banks would have to be restricted to traditional services or a way of projecting potential cost to the insurance fund in a "fail-safe" scenario would have to be independently developed and applied. Yet, if potential cost to the insurance fund is to be the standard for risk assessment, the smallest institutions should be the least restricted in their non-traditional activities. Of course, protection of the insurance fund and assessment of risk to the fund should not be the objective of this exercise.

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The concept of originally underlying the foundation of the Federal Deposit Insurance Act was one of establishing protection for depositors. Over the years, the situation has evolved through practice and regulation to become more or less a system for insuring the institution. Adoption of a risk related premium based on the health or activity of an institution is not depositor orientated and would ratify that evolution. It is true that depositors will be covered for the insured amount of their deposit, but it becomes secondary to the condition of the institution. Moreover, many arguments which have been put foreward even suggest that the truly determining factor is risk to the fund itself, that you must insure the insuror.

CSBS, over the years, has held - and so testified - that increasing deposit insurance coverage had removed market discipline from the industry. If there would be a politically acceptable way of lowering the maximum deposit insurance coverage back to $40,000, we believe that it would return the focus to the depositor and away from the institution. Furthermore, such a lowering of the depositor insurance coverage would automatically increase the opportunity for market discipline to work its way as many more depositors in the $40,000 to $100,000 range would be faced with having exposed funds. Small savers would remain unaffected. In addition, the ability to broker funds on an insured basis would be made more difficult. This could reduce the exposure of risk claimed to be associated with this activity.

Public criticism of any attempt to lower deposit insurance

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coverage could be expected and it might be difficult to explain the reality of the situation. Deposit data from 1980, which is the last time the FDIC collected information by deposit size, shows that 59.4% of the deposits of individuals, partnerships and corporations (IPC) in commercial banks were in accounts of $40,000 or less. Deposits of over $100,000 held 31.2%, leaving a mere 9.4% of IPC deposits in the accounts ranging between $40,000 and $100,000. If more current data shows that these portions have not changed greatly, public concern may be very limited. Public concern could be further mollified by maintaining the current level on IRA's and possibly other personal accounts. Certainly, the reduction of insurance coverage should be seriously considered as an alternative form of deposit insurance reform.

Before leaving the subject of risk related premiums, I would simply note for the record, that CSBS would oppose combining the FDIC and the FSLIC. We have testified to this end on several occasions and would not belabor the point at this juncture.

RISK BASED CAPITAL

The use of a risk based capital system holds many of the same difficulties as a risk related premium. It too would have to be essentially a judgmental decision made by individual regulators on a case-by-case basis. The capital assessment on an individualized basis is not a new concept to bank supervision, and runs counter to the recent efforts to achieve uniform capital standards. It appears reasonable to assume that in such a system

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the standard would become a floor, and upward adjustments would be made on a risk assessment basis.

A risk related capital system penalizes a bank in a more significant way than a risk related premium. It would require an institution to maintain more capital to support an asset base equal in size to that of a bank engaged in less risky activities. Forcing "risky" banks to raise additional capital creates a trauma for the ownership and management of the bank, because they run the risk of having to dilute their control of the institution, something most are reluctant to do. Customers and the public at large would actually gain from the process, as increased capital in the bank is made available to protect their interests.

One drawback to this concept relates to institutions which might benefit from new products or services, but which have deteriorated to a point where it is all but impossible to raise new capital. Again, the difficulty in accurately forecasting the future condition of a bank interferes with the current assessment of risk upon which to base capital requirements.

PUBLIC DISCLOSURE AS A SUPERVISORY TOOL

CSBS does not endorse the concept of public disclosure as a supervisory tool and believes improper public disclosure would be counterproductive. CSBS recommends that if, for some unforeseen reason, public disclosure must be used as a supervisory tool in the regulation of financial institutions, its requirements should emphasize deterrence rather than punishment for the institutions,

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be clearly understandable to and understood by the general public, be phased in on an orderly basis and should have uniform and consistent application to all types of financial institutions. As an idealistic concept, public disclosure to protect interests of innocent citizens has a measure of validity. Disclosure proposals to date, however, have not been primarily for that purpose and/or have not met ths aforementioned criteria necessary to meet the public interest test.

Confidentiality of information regarding the financial conditions of banks is not a historical accident. It is naieve to believe that an adequate level of understanding of such information can be readily achieved or that a run on a bank could not occur as a result of misunderstood or misinterpreted information.

The stated objective of the FDIC in calling for increased disclosure of bank information to the public is to promote better informed customer decisions and, thus, more effective market discipline. CSBS does not believe that this purpose would be served in any large measure. Large, sophisticated depositors are already aware of publicly available data, and other depositors are unlikely to be reached as to data availability and its use. Even the news media with its propensity to misinterpret data is already aware of public information and, perhaps fortunately, has not widely disseminated their versions of it.

Written statements often can be misinterpreted or have several meanings. Obviously, institutions will desire to present

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themselves in the most favorable light, and skilled draftsmen will be retained in some case to maximize the gain and/or minimize the loss from public releases of narrative explanations of data. At the least, a condition is being created that can lead to significant misinformation - intentional or not - by encouraging public demands for narrative explanations of data from the institutions.

The legal responsibility for the accuracy of information must be borne by the disseminator of the information. Thus, by requiring banks to disseminate information, the FDIC would be increasing the risk exposure of banks. Legal liability for simple reporting errors could be all too real. By legally absolving itself from passing on the accuracy and adequacy of the information, the FDIC, with full knowledge of the institution via a bank examination report and other analytical tools, indicates disengagement from the passage of information between the regulated and the public.

Requiring the disclosure of enforcement actions might actually work against improved bank supervision. The required disclosure of cease and desist orders could cause both state and federal regulators to withhold issuance in borderline situations to avoid possible inappropriate adverse public reaction as a result of disclosure. This would be extremely counter productive, since the proper use of cease and desist orders has been one of the most effective supervisory tools in recent years.

Finally, there is great potential for unfairness in the

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application of public disclosure proposals. Proposals to date have not applied evenly to all financial institutions. State-chartered nonmember banks, in particular, have been singled out. Banks and thrifts insured by the FDIC have been singled out to release more data than other financial institutions. Subject proposals, if adopted, would mean more regulation would be imposed on the already highly regulated at a time when nontraditional but competitive depository-type institutions are permitted to operate with less supervisory burden. Even-handedness in application of public disclosure proposals, to-date, remains an elusive goal.

Public disclosure proposals have many aspects of prescribing a cure that is worse than the illness. The restoration of weak financial institutions back to health is normally the goal of bank supervision. The disclosure of reports, regulatory judgments and actions can be justified as an additional supervisory tool only if it is presented in a constructive manner and serves the long run public interest.

SUMMARY AND CONCLUSION

Our unique American dual banking system is marked by shared responsibility between several agencies in different roles. The state banking departments and the Office of the Comptroller of the Currency act as the primary regulators of the institutions they charter. As the primary regulators, both are charged with a broad public interest responsibility toward the entire community served by the banks they regulate.

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The majority of bank failures have historically been attributed to fraud, improper loans to bank-related individuals and managerial weakness. These matters are the responsibility of the primary regulator. In current failures it is possible to discover some of all these elements. However, in the case of widespread institutional failures, the state of the economy and economic policy can be seen as a major contributing factor. Macroeconomic variables cannot, for the most part, overcome by regulatory fiat.

In the past two years the number of bank failures has reached post-depression records. This situation has brought the role of the FDIC to the forefront. As the Federal insuror of deposits, it must concern itself with both the decline in public confidence in our financial institutions and the need to preserve the assets of the insurance fund. The FDIC has done well in fulfilling its statutory responsibility during these difficult times. It must be remembered, however, that the role of the FDIC is limited by its charter and that role does not encompass the full breadth of public interest concerns embodied in our system of bank regulation.

It has always been the responsibility of the primary regulator to determine both the appropriate time for a bank to be closed and the circumstances thereof. Obviously, there are implications for the insuror of the institution in both the timing and the way in which the closing is handled. Therefore, as in most areas of modern bank regulation a great deal of

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cooperation is required between the primary bank regulator and the FDIC.

Most state statues provide a rather specific description of the conditions that would require the respective Supervisor to close the bank. For all practical purposes the state is bound by those requirements. However, state bank supervisors do exercise a degree of judgemental discretion in dealing with institutions that are on course leading to failure. Every effort is made to restore problem institutions to a healthy state and maintain their service to the community. There is a point, however, where the primary regulator can determine that the erosion of equity capital will continue unabated and that termination of the charter by the chartering authority is the least undesirable of existing options.

Once it becomes apparent that an institution must be closed, the timeliness of actions and selection of procedures to be followed is critical in bringing about a favorable resolution of the situation. Whether we are dealing with a critically wounded institution or a closed one, the disposition should take the form that is least disruptive, most efficient, and least costly. Since each failure situation presents a new set of particularized circumstances, each with its own problems, it is not possible to have a general rule as to the appropriate way to manage a failure. It must be remembered that merger, purchase and assumption, conservatorship, and liquidation are merely tools, the choice of which depends on the likelihood that each will

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fashion the desired end in a particular set of circumstances. It is important that the respective interests of all segments of the public be considered. We believe it preferable to tailor a prescription to meet each specific situation with the primary regulator taking the lead. Experience has shown that an efficient and minimally disruptive solution can be accomplished at a relatively low cost to the FDIC fund. In some cases, the regulatory tool selected to meet broader objectives may not represent the lowest projected cost. Historically, however, there has not been a wide spread between the actual loss figures for the various tools. Given the purposes for which the FDIC fund was established, it is often appropriate for the fund to absorb an incremental additional cost in order to maintain services in a trade area, public confidence in financial institutions and stability in the banking system.

CSBS would oppose attempts to amend section 116 of the Garn-St. Germain Depository Institutions Act of 1982 to allow the FDIC to arrange the sale of the assets of a "failing" bank rather than a bank which has been closed. First, such an amendment is unnecessary. State laws and regulations have provided adequate flexibility to arrange such transactions and, in several cases, have been specifically amended to accomodate the interests of the FDIC in handling failing banks. Second, allowing the FDIC to, in essence, close a bank would be a severe breach of our system of bank chartering and regulation. Third, allowing the insuror to close an institution may well lead to closing institutions for

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the wrong reason: protection of the insurance fund.

The FDIC fund was created to protect depositors and to promote the stability of the banking system. Banks have contributed to the fund for these purposes. An incremental cost to the fund, incurred to serve the broader policy objectives set by Congress, is often appropriate and best serves the public interest.

State banking departments are constantly improving the assessment techniques used in determining the conditions of financial institutions. They are taking the initiative in developing necessary analytical tools, improving on personnel skills, and building lines of communication with other concerned agencies.

During the last year, several states have acted to increase state bank investment powers through statutory initiatives. Generally, language in these legislative efforts contain some type of restriction on investments (caps on percentage of investment, requirement to invest through subsidiary, CRA requirements and others). California and New York, as examples, have drafted solid, comprehensive regulations to go along with the increased investment powers. Other states that have recently enacted enabling powers legislation are carefully monitoring bank activities in these areas to determine if additional regulatory guidlines will be required to ensure the safety and soundness of participating institutions. The point is, that states which elect to expand bank powers and allow some increase in the mixing

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of banking and commerce have done so responsibly and have increased their regulatory efforts. CSBS would strongly oppose the expansion of FDIC authority over the activities of banks at the expense of the authority of the primary regulators. CSBS believes that the federal agencies should not be permitted to set industry-wide aggregate and individual limits on approved activities.

A basic goal of CSBS is to help states meet their educational needs in order to improve the quality of bank supervision. The benefits of this program accrue to banking departments, the banking community and the public at-large. Educational requirements and needs of the banking departments have undergone unprecedented growth during the past 10 years.

CSBS has chosen to respond to the challenge of an increasing educational committment by establishing the Education Foundation of the State Bank Supervisors. The Foundation offers a wide range of educational opportunities as well as a Scholarship Assistance Program to worthy applicants.

Any effort to improve the quality of bank regulation must be firmly grounded in efforts to maintain and improve the quality of the regulatory agencies themselves, in our case, the state banking departments. The majority of state banking departments are as well, or better equipped to charter and supervise their institutions than are their federal counterparts.

CSBS has developed two voluntary programs -- Department Self-Evaluation and State Banking Department Accreditation --

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designed to help state regulators preserve the current dual banking system and meet their own, diverse professional and managerial needs.

No federal agency undergoes a comparable, rigorous standards review. CSBS believes that once a state has completed this review and has been accredited, federal agencies should accept the examination reports and findings of that state unless the agency can show cause why it should not. In essence, the burden of proof of the quality of state supervision would be shifted from the state to the federal agency in accredited states. Of course, the FDIC would continue its presence in the examination and supervision of state-chartered problem banks to the same extent it had such a presence in national banks.

The concept of a risk related premium for deposit insurance has a significant initial appeal. It seems to make good sense that an institution that is behaving in a risky or an extraordinarily aggressive manner should pay a higher premium for insurance coverage than other institutions. However, recent history has shown that even the most conservatively run institution can fall into the trap of adverse economic conditions such as volatile interest rates, declines in commodity prices, and declining real estate values. The risk of doing the business of banking has increased for those confined to traditional activities as well as for those who have expanded their range of services.

The two major problems associated with a risk based deposit

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insurance premium are determining the appropriate measure of risk for various activities of the institution, including the question of who should make this determination, and determining the difference in premium charge sufficient to produce the desired effect. Presumably, a higher premium should make the management an institution think twice before commencing a rated activity or conversely, should cover the cost of greater losses to the insurance fund resulting from institutions engaging in such activities.

CSBS believes that the problems inherent in properly assessing risk based premiums may well outweigh its potential benefit. If there is to be such a system, risk should be associated with what an individual institution is doing in a specific market and should take into consideration the institution's performance record. This case-by-case assessment would not lend itself to generalized formulae. Rather, the determination of a risk premium should be the responsibility of the primary regulator, which has the ability to delve into the specifics of an individual case to assemble and analyze the relevant information.

CSBS over the years, has held - and so testified - that increasing deposit insurance coverage had removed market discipline from the industry. If there would be a politically acceptable way of lowering the maximum deposit insurance coverage back to $40,000, we believe that it would return the focus to the depositor and away from the institution. Furthermore, such a

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lowering of the depositor insurance coverage would automatically increase the opportunity for market discipline to work its way as many more depositors in the $40,000 to $100,000 range would be faced with having exposed funds. Small savers would remain unaffected. Certainly, the reduction of insurance coverage should be seriuosly considered as an alternative forum of deposit insurance reform.

The use of a risk based capital system holds many of the same difficulties as a risk related premium. It too would have to be essentially a judgmental decision made by individual regulators on a case-by-case basis.

A risk related capital system penalizes a bank in a more significant way than a risk related premium. It would require an institution to maintain more capital to support an asset base equal in size to that of a bank engaged in less risky activities. Forcing "risky" banks to raise additional capital creates a trauma for the ownership and management of the bank, because they run the risk of having to dilute their control of the institution, something most are reluctant to do. Customers and the public at large would actually gain from the process, as increased capital in the bank is made available to protect their interests.

CSBS does not endorse the concept of public disclosure as a supervisory tool and believes improper public disclosure would be counterproductive. CSBS recommends that if, for some unforeseen reason, public disclosure must be used as a supervisory tool in

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the regulation of financial institutions, its requirements should emphasize deterrence rather than punishment for the institutions, be clearly understandable to and understood by the general public, be phased in on an orderly basis and should have uniform and consistent application to all types of financial institutions. As an idealistic concept, public disclosure to protect interests of innocent citizens has a measure of validity. Disclosure proposals to date, however, have not been primarily for that purpose and/or have not met the aforementioned criteria necessary to meet the public interest test.

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The CHAIRMAN. Thank you, Mr. Bailey.
Mr. Bowman.

STATEMENT OF L.L. BOWMAN, COMMISSIONER, TEXAS SAVINGS AND LOAN DEPARTMENT, AUSTIN, TX; PRESIDENT, BOARD OF DIRECTORS, NATIONAL ASSOCIATION OF STATE SAVINGS AND LOAN SUPERVISORS*

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*The members of the National Association of State Savings and Loan Supervisors are the state officials who regulate state-chartered savings and loan institutions in the several states and territories. The members of NASS&LS supervise and examine some 2,300 state-chartered institutions with assets of approximately $250 billion. The members of the Board of Directors of NASS&LS are: L.L. Bowman III, Commissioner of the Texas Savings and Loan Department, State of Texas; George C. King, Administrator of the Savings and Loan Division, State of North Carolina; David L. Paul, Commissioner of the Division of Savings and Loan, State of Colorado; Charles H. Brown, Jr., Director of the Division of Savings and Loans, State of Maryland; William B. Lewis, Deputy Commissioner of the Division of Savings and Loan Associations, State of New Jersey; R.H. Lewis, Supervisor of the Division of Savings and Loan Associations, State of Washington; R.J. McMahon, Commissioner of the Office of Savings and Loans, State of Wisconsin; Gerald Oliver, Deputy Comptroller, Bureau of Thrift, Savings and Loan Section, State of Florida; and L. Scott Walshaw, Administrator of the Financial Institution Division, State of Nevada.

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MR. CHAIRMAN AND DISTINGUISHED MEMBERS OF THIS COMMITTEE, MY NAME IS L.L. BOWMAN, III AND I AM PRESIDENT OF THE BOARD OF DIRECTORS OF THE NATIONAL ASSOCIATION OF STATE SAVINGS AND LOAN SUPERVISORS. ADDITIONALLY, I AM THE COMMISSIONER OF THE TEXAS SAVINGS AND LOAN DEPARTMENT. I APPRECIATE THIS OPPORTUNITY TO PROVIDE THE VIEWS OF NASS&LS ON WHAT WE BELIEVE TO BE AN EXTREMELY IMPORTANT AND TIMELY SUBJECT MATTER--THE SUPERVISORY AND EXAMINATION PROCESSES WITHIN OUR PRESENT REGULATORY FRAMEWORK AND A REEXAMINATION OF THE CONCEPT AND IMPLEMENTATION OF OUR DEPOSIT INSURANCE SYSTEM. MY TESTIMONY TODAY WILL FOCUS ON THE SAVINGS AND LOAN INDUSTRY AND ITS STATUS AS AN INTEGRAL ELEMENT OF THIS COUNTRY'S FINANCIAL SERVICES INDUSTRY. MY TESTIMONY WILL, BY NECESSITY, BRIEFLY TOUCH UPON THE POINTS RAISED BY THIS DISTINGUISHED COMMITTEE AS WELL AS CERTAIN OTHERS WHICH NASS&LS FEELS ARE GERMANE TO THE SUBJECT MATTER AT HAND. HOWEVER, PLEASE DO NOT BE MISLED BY THE BREVITY OF MY TESTIMONY, THE ISSUES BEFORE THIS COMMITTEE TODAY ARE EXTREMELY COMPLEX AND COULD BE THE SUBJECT OF EXTENSIVE ANALYSIS AND DISCUSSION. IT IS NASS&LS HOPE THAT THESE HEARINGS WILL INDEED FOSTER SUCH ANALYSIS AND DISCUSSION IN THE COMING MONTHS AS CONGRESS ATTEMPTS TO ADDRESS THE CONCERNS SHARED BY US ALL REGARDING THE MAINTENANCE OF A SOUND FINANCIAL SERVICES INDUSTRY.

ASSESSMENT OF THE CONDITION OF FINANCIAL INSTITUTIONS

NASS&LS WOULD LIKE TO ONCE AGAIN GO ON RECORD AS ACKNOWLEDGING THAT THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION AND THE FEDERAL DEPOSIT INSURANCE CORPORATION ARE THE DEPOSIT INSURANCE FUNDS WHICH HAVE IN THE PAST, DO PRESENTLY, AND WILL CONTINUE TO INSTILL PUBLIC CONFIDENCE IN OUR FINANCIAL INSTITUTION SYSTEM. AS WE ARE ALL TOO WELL AWARE, PUBLIC CONFIDENCE IS THE LINCHPIN TO ANY SYSTEM OF FINANCIAL INTERMEDIATION, NOT ONLY IN THIS COUNTRY BUT IN THE FREE WORLD AS WELL. TO MAINTAIN THIS PUBLIC CONFIDENCE IT IS INCUMBENT UPON NOT ONLY THE FEDERAL GOVERNMENT BUT ALSO THE RESPECTIVE STATE GOVERNMENTS TO SEE THAT ALL FINANCIAL INTERMEDIARIES CONDUCT THEIR OPERATIONS IN A SAFE AND SOUND MANNER. IT IS NOT AND SHOULD NOT BE THE SOLE PURVIEW OF THE FEDERAL GOVERNMENT TO OVERSEE THE OPERATIONS OF THE VARIOUS FORMS OF FINANCIAL INSTITUTIONS IN THIS COUNTRY TODAY. RATHER, NASS&LS BELIEVES THAT IT IS THE RESPONSIBILITY OF CONGRESS TO CRAFT MINIMUM OPERATIONAL STANDARDS FOR ALL

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FINANCIAL INSTITUTIONS IN THIS COUNTRY, BOTH FEDERALLY CHARTERED AND STATE CHARTERED. IT IS THEN THE RESPONSIBILITY OF THE VARIOUS STATE LEGISLATURES TO DETERMINE APPROPRIATE OPERATIONAL STANDARDS WITHIN THIS OVERALL FRAMEWORK. THIS CONCEPT IS NOT WITHOUT PRECEDENT. THE DISBURSEMENT OF FEDERAL HIGHWAY FUNDS TO THE VARIOUS STATES IS ONE SUCH EXAMPLE. IF THE STATE IS NOT IN COMPLIANCE WITH MINIMUM STANDARDS AS ESTABLISHED BY THE FEDERAL GOVERNMENT, THEN FUNDS MAY BE WITHHELD.

THE ISSUE OF IMPROVING OUR ABILITY, AS REGULATORS, TO ASSESS THE FINANCIAL AND OPERATIONAL CONDITION OF A FINANCIAL INSTITUTION IS CRITICAL. REGULATORS, BE THEY FEDERAL OR STATE, MUST BE SUPPLIED WITH THE MOST TIMELY DATA AVAILABLE IF THEY ARE TO ADEQUATELY FULFILL THEIR RESPONSIBILITIES. THE DEREGULATED ENVIRONMENT IN WHICH WE FIND OURSELVES TODAY HAS PROMPTED FINANCIAL INSTITUTIONS TO IMPLEMENT PROGRAMS AND POLICIES WHICH HERETOFORE WERE UNHEARD OF. THE ISSUES OF TIMELY DATA AND IMPROVED ANALYTICAL TECHNIQUES ARE ONES WHICH BOTH FEDERAL AND STATE REGULATORS ARE ATTEMPTING TO RESOLVE. IN AN EFFORT TO "KEEP-UP" WITH THE INDUSTRY CERTAIN STATES HAVE BEGUN TO RESPOND TO WHAT IS PERCEIVED TO BE AN INFORMATIONAL GAP. THE OFFICE OF SAVINGS AND LOANS OF THE STATE OF WISCONSIN HAS IMPLEMENTED A FULLY AUTOMATED SYSTEM TO CONDUCT ONGOING AND PRELIMINARY REVIEWS OF WISCONSIN CHARTERED SAVINGS AND LOANS. MY OWN STATE OF TEXAS HAS RECENTLY INITIATED A COMPREHENSIVE MONITORING SYSTEM FOR STATE CHARTERED SAVINGS AND LOANS WHICH WILL GREATLY ENHANCE THIS REGULATORS ABILITY TO ASSESS THE CONDITION OF TEXAS CHARTERED SAVINGS AND LOANS. FOR YOUR CONVENIENCE I HAVE ATTACHED HERETO AS EXHIBIT I A COPY OF THIS MONITORING SYSTEM. IN ADDITION, THE TEXAS LEGISLATURE HAS RECENTLY REVISED AND RECODIFIED THE TEXAS SAVINGS AND LOAN CODE IN AN EFFORT TO PROVIDE THE SAVINGS AND LOAN DEPARTMENT WITH EXPANDED AUTHORITY IN DEALING WITH INSTITUTIONS UNDER ITS JURISDICTION. THESE EXPANDED POWERS INCLUDE THE ABILITY TO ISSUE CEASE AND DESIST ORDERS, INSTITUTE CONSERVATORSHIPS AND MORE CLOSELY REGULATE ANY CHANGE IN CONTROL (INCLUDING HOLDING COMPANIES) OF SAVINGS AND LOANS CHARTERED IN THE STATE OF TEXAS. CLEARLY, FOR ANY REGULATOR, STATE OR FEDERAL, TO EFFECTIVELY CARRY OUT HIS OR HER RESPONSIBILITIES THE LAW MUST PROVIDE THAT REGULATOR WITH THE AUTHORITY AND POWERS NECESSARY TO DO SO. ABSENT THIS GRANT OF POWERS, THE REGULATOR IS ILL EQUIPPED IN TODAYS DEREGULATED MARKET PLACE TO ADDRESS THE PROBLEMS BEFORE THEY BECOME UNMANAGEABLE.

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THE QUANTITY AND QUALITY OF PERSONNEL

NASS&LS BELIEVES THAT THE ISSUE IS NOT AND SHOULD NEVER BECOME ONE OF WHETHER FEDERAL EXAMINATION AND SUPERVISORY PERSONNEL ARE "BETTER" THAN THEIR STATE COUNTERPARTS. TO ENGAGE IN A FRUITLESS DEBATE OF THIS NATURE WOULD ONLY ENGENDER ILL WILL AND CREATE AN UNWARRANTED "TURF" BATTLE, WHILE LOSING SIGHT OF THE REAL ISSUES. THE PRESERVATION OF PUBLIC CONFIDENCE IN A SAFE AND SOUND FINANCIAL INSTITUTION SYSTEM (ULTIMATELY FOR THE BENEFIT OF THE CONSUMER) SHOULD BE THE PRIMARY GOAL OF EACH OF US HERE TODAY. MY DUTY AS A REGULATOR IS NOT TO PROTECT THE INSURANCE FUND AT ALL COSTS. RATHER, MY DUTY IS TO PRESERVE THE SAFETY AND SOUNDNESS OF THE FINANCIAL INSTITUTION SYSTEM, FOR THE BENEFIT OF THE CONSUMER, OF WHICH THE INSURANCE FUNDS ARE AN INTEGRAL ELEMENT THEREOF. ONE WAY IN WHICH NASS&LS BELIEVES THAT THE SAFETY AND SOUNDNESS OF THE FINANCIAL INSTITUTION SYSTEM MAY BE ENHANCED IS FOR A UNIFORM STANDARD TO BE ESTABLISHED FOR EXAMINATION AND SUPERVISORY PERSONNEL. SUCH A STANDARD, WITH ITS QUALIFICATION AND MAINTENANCE REQUIREMENTS, WOULD APPLY EQUALLY TO FEDERAL AND STATE LEVEL EXAMINERS AND SUPERVISORS. IN THIS WAY NO CLAIMS COULD BE LEVELED IN EITHER DIRECTION REGARDING QUALITY OF PERSONNEL. ADDITIONALLY, AS IT SHOULD BE IN ANY CASE, STATE AND FEDERAL EXAMINATION AND SUPERVISORY PERSONNEL SHOULD COMPLIMENT ONE ANOTHER BY WORKING IN TANDEM WITH A FREE EXCHANGE OF INFORMATION AND IDEAS. A COMBINED EFFORT WOULD SURELY BE MORE SUCCESSFUL IN PROTECTING THE AMERICAN CONSUMERS INTEREST THAN A BIFURCATED APPROACH.

ASSET DEREGULATION

IN LIGHT OF THE OBSERVATIONS I HAVE BRIEFLY SET FORTH ABOVE, AND KEEPING IN MIND THAT AS OF TODAY THIS CONGRESS HAS DEREGULATED THE LIABILITY SIDE OF A FEDERALLY CHARTERED SAVINGS AND LOANS' BALANCE SHEET, BUT NOT THE ASSET SIDE, WE MUST AGAIN VISIT THE ISSUE OF STATES RIGHTS AND THE DUAL SYSTEM OF CHARTERING AND REGULATION. I WILL NOT BURDEN THIS DISTINGUISHED COMMITTEE BY REPEATING THE SUBSTANCE OF A POSITION THAT HAS BEEN PRESENTED BY NASS&LS ON SEVERAL PRIOR OCCASIONS, BUT RATHER, WILL SIMPLY STATE THAT THE DUAL SYSTEM OF CHARTERING AND REGULATION HAS SERVED THIS COUNTRY WELL OVER THE YEARS AND I STEADFASTLY BELIEVE IT SHALL CONTINUE TO DO SO IN THE FUTURE.

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SEVERAL STATE LEGISLATURES HAVE ENACTED STATUTES WHICH GRANT EXPANDED ASSET AUTHORITY TO DOMESTIC SAVINGS AND LOANS BEYOND THOSE AVAILABLE TO FEDERALLY CHARTERED SAVINGS AND LOANS. A BALANCE MUST AND CAN BE STRUCK BETWEEN THE VALID CONCERNS OF THE FSLIC AND THE EQUALLY VALID CONCERNS OF STATE LEGISLATURES PERTAINING TO THE LENDING AND INVESTMENT AUTHORITY OF STATE CHARTERED SAVINGS AND LOANS. WHAT IS APPROPRIATE FOR ONE AREA OF THE COUNTRY AND THEREBY BENEFITING CONSUMERS OF THAT AREA IS NOT NECESSARILY APPROPRIATE FOR ANOTHER AREA OF THE COUNTRY OR THE CONSUMERS WHO RESIDE THERE. IF THE MONITORING AND EXAMINATION AND SUPERVISORY GUIDELINES OUTLINED ABOVE HAVE BEEN ACHIEVED, AND MINIMUM NATIONAL STANDARDS RELATIVE TO GROWTH AND DIVERSIFICATION OF ASSETS HAVE BEEN ESTABLISHED, THEN IT SHOULD BE LEFT TO THE RESPECTIVE STATE LEGISLATURES TO DETERMINE APPROPRIATE LENDING AND INVESTMENT POWERS FOR THEIR DOMESTIC SAVINGS AND LOANS. AS AN INCENTIVE, IF A STATE CHARTERED SAVINGS AND LOAN MEETS STATUTORY AND REGULATORY REQUIREMENTS, THEN IT SHOULD HAVE THE FREEDOM TO DETERMINE, WITHIN STATUTORILY DEFINED PARAMETERS, WHAT IS AN APPROPRIATE LOAN OR INVESTMENT FOR ITS MARKET AREA. AS MENTIONED ABOVE, MINIMUM NATIONAL STANDARDS RELATING TO GROWTH AND DIVERSIFICATION OF ASSETS MUST BE ESTABLISHED AND USED AS A BENCHMARK. THERE ARE BEFORE THIS CONGRESS SEVERAL BILLS WHICH ENCOMPASS THE CONCEPT OF A QUALIFIED THRIFTNESS TEST. NASS&LS EMBRACES SUCH A CONCEPT AND WOULD HOPE THAT ALL CONCERNED PARTIES COULD WORK TOGETHER TO CRAFT A PROVISION WHICH WOULD ADDRESS THIS POINT. DEREGULATION OF THE ASSET SIDE OF THE BALANCE SHEET IS IMPERATIVE. ACKNOWLEDGING THE PUBLIC POLICY CONCERN FOR HOME FINANCING, CONGRESS MUST ADDRESS THE DEMOGRAPHICS. THE BOOM IN MORTGAGE LENDING EXPERIENCED IN THE POST WORLD WAR II ERA IS NO LONGER A REALITY. FURTHER, DISINFLATION, WHILE WELCOME TO CONSUMERS ON THE WHOLE, HAS HAD A NEGATIVE IMPACT ON THE REAL ESTATE MARKETS ACROSS THE COUNTRY. EXPANDED ASSET POWERS TO BE USED AS AN INCENTIVE TO MEET AND MAINTAIN ESTABLISHED FINANCIAL AND OPERATIONAL STANDARDS IS ONE APPROACH TO COMING TO GRIPS WITH A MARKET PLACE WHICH SEEMS TO EVOLVE AND ADAPT TO MARKET FORCES FASTER THAN LEGISLATORS AND REGULATORS CAN REACT. IF A STATE CHARTERED SAVINGS AND LOAN CANNOT MEET AND MAINTAIN ESTABLISHED STANDARDS THEN IT SHOULD NOT BE EXEMPT FROM OPERATING BEYOND THOSE POWERS GRANTED TO FEDERALLY CHARTERED SAVINGS AND LOANS.

IN THE OPINION OF NASS&LS, EXPANDED INVESTMENT AUTHORITY FOR STATE CHARTERED SAVINGS AND LOANS HAS NOT BEEN THE CULPRIT RESULTING IN TODAYS ASSET PROBLEMS

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WITHIN THE SAVINGS AND LOAN INDUSTRY. THE SAVINGS AND LOAN INDUSTRY HAS FALLEN INTO ITS PRESENT POSITION THE OLD FASHION WAY, POOR BUSINESS JUDGMENT AND APPARENT GREED, NOT BY ILLCONCEIVED STATE LAW OR LACK OF REGULATION OR SUPERVISION. ON THIS POINT I WILL ONLY STATE THAT NASS&LS IMPLORES THIS CONGRESS TO EXPRESSLY DIRECT THE DEPARTMENT OF JUSTICE AS WELL AS OTHER LAW ENFORCEMENT AGENCIES, IN CONJUNCTION WITH THE RESPECTIVE STATE LAW ENFORCEMENT AGENCIES, TO PURSUE AND PROSECUTE THOSE INDIVIDUALS WHO WRONGFULLY CONVERT THE PROPER PURPOSES OF SAVINGS AND LOANS FOR THEIR OWN PERSONAL BENEFIT.

THE QUALITY OF ASSETS PROBLEM IS BY NO MEANS LIMITED TO THE SAVINGS AND LOAN INDUSTRY. THE SAVINGS AND LOAN INDUSTRY IS NO MORE A VICTIM OF ITS BAD LOANS THAN ANY OTHER AREA OF OUR FINANCIAL SERVICES INDUSTRY. COMMERCIAL BANKS HAVE THEIR ENERGY AND AGRICULTURE LOANS AND THE MONEYCENTER BANKS HAVE THEIR PORTFOLIOS LADEN WITH FOREIGN LOANS WHICH ARE QUESTIONABLE AT BEST. LEGISLATURES MUST PROVIDE AN INCENTIVE TO SAVINGS AND LOAN EXECUTIVES TO MEET AND MAINTAIN FINANCIAL AND OPERATIONAL STANDARDS THEREBY OPENING THE DOOR TO EXPANDED ACTIVITIES.

RESPONSES TO THE PRESENT DIFFICULTIES

NASS&LS BELIEVES THAT ONE RESPONSE TO THE PRESENT STATE OF AFFAIRS IS TO DECENTRALIZE THE FSLIC. AS SUGGESTED IN THE TESTIMONY OF MR. JAY JANIS, FORMER CHAIRMAN OF THE FEDERAL HOME LOAN BANK BOARD, A DECENTRALIZATION OF THE FSLIC WOULD IMPROVE ITS ABILITY TO COPE WITH THE SERIOUS PROBLEMS WHICH IT NOW FACES. NASS&LS IS OPPOSED TO THE MERGING OF THE FDIC AND THE FSLIC. THE RESPONSIBILITIES OF THE FSLIC COULD BE DISBURSED TO THE DISTRICT BANKS OF THE FEDERAL HOME LOAN BANK SYSTEM. ALTERNATIVELY, A DECENTRALIZED FSLIC COULD BE STRUCTURED AS AN INDEPENDENT NETWORK. IN ANY EVENT, NASS&LS STRONGLY BELIEVES THAT THE RESPECTIVE STATE SUPERVISORS SHOULD HAVE A LARGER VOICE IN THE USAGE OF THE FSLIC FUNDS. STATE SUPERVISORS SHOULD BE GIVEN ACCESS TO THE FUNDS IN CONJUNCTION WITH THE FEDERAL AUTHORITIES BECAUSE THEY ARE MORE COGNIZANT OF WHAT IS HAPPENING TO THEIR RESPECTIVE STATE CHARTERED SAVINGS AND LOANS THAN THE FEDERAL AUTHORITIES. WITH STATUTORILY GRANTED POWERS SUCH AS THOSE DESCRIBED ABOVE FOR MY OWN STATE OF TEXAS, SWIFT ACTION OFTEN CAN CONTAIN A PROBLEM BEFORE IT GROWS OUT OF CONTROL. AGAIN, I CANNOT STRESS ENOUGH THE NEED FOR TEAM WORK

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AND OPEN LINES OF COMMUNICATION BETWEEN FEDERAL AND STATE REGULATORS TO MORE EFFECTIVELY DEAL WITH THE CHANGING FACE OF THE SAVINGS AND LOAN INDUSTRY.

NASS&LS RESPECTFULLY OFFERS A SECOND APPROACH IN RESPONSE TO THE PRESENT SITUATION IN THE SAVINGS AND LOAN INDUSTRY. ATTACHED HERETO AS EXHIBIT II IS A COPY OF RECENTLY ENACTED LEGISLATION FROM MY OWN STATE OF TEXAS. THIS ACT, WHICH IS ENTITLED THE "TEXAS SAVINGS AND LOAN SUPPLEMENTAL FUND ACT," WAS CREATED FOR THE FOLLOWING PURPOSE:

> A FUND IN TEXAS TO AID AND ASSIST THE SAVINGS AND LOAN COMMISSIONER OF TEXAS IN MAINTAINING THE SOLVENCY OF THE ASSOCIATIONS THAT CONTRIBUTE TO THE FUND AND TO SAFEGUARD THE PUBLIC INTEREST AND PROMOTE THE PUBLIC CONFIDENCE IN STATE CHARTERED SAVINGS AND LOAN ASSOCIATIONS DOING BUSINESS IN THE STATE OF TEXAS BY MAKING AVAILABLE TO THE SAVINGS AND LOAN COMMISSIONER OF TEXAS THE ADDITIONAL RESOURCE OF THIS FUND TO BE USED FOR THE PROTECTION AND REHABILITATION OF MEMBER ASSOCIATIONS' ASSETS AS WELL AS THE MAINTENANCE OF THE SOLVENCY OF MEMBER ASSOCIATIONS.

THE PRACTICAL EFFECT OF THIS SUPPLEMENTAL FUND IS TO INDEMNIFY THE FSLIC WHILE THE FSLIC REMAINS THE INSURER OF DEPOSITS. THE SUPPLEMENTAL FUND WOULD INSURE THE ASSETS OF THOSE STATE CHARTERED SAVINGS AND LOANS WHO ARE CONTRIBUTORS TO THE SUPPLEMENTAL FUND. IN EXCHANGE FOR THIS SUPPLEMENTAL CONTRIBUTION THE MEMBER ASSOCIATION MAY EXERCISE THE AUTHORITY GRANTED TO IT BY THE STATE LEGISLATURE (KEEPING IN MIND THE MINIMUM NATIONAL STANDARDS DISCUSSED ABOVE). STATE CHARTERED SAVINGS AND LOANS WHICH ARE NOT MEMBERS OF THE SUPPLEMENTAL FUND WOULD NOT HAVE THE AUTHORITY TO EXERCISE LENDING AND INVESTMENT AUTHORITY BEYOND THAT GRANTED TO FEDERALLY CHARTERED SAVINGS AND LOANS. THE TEXAS SUPPLEMENTAL FUND WILL INITIALLY BE CAPITALIZED BY EACH ASSOCIATION TRANSFERRING TO THE SUPPLEMENTAL FUND 2% OF ITS TANGIBLE ASSETS IN RETURN FOR AN INVESTMENT CERTIFICATE. THE RETURN ON THIS INVESTMENT WILL BE 2% BELOW THE MARKET RATE OF RETURN. THE SPREAD WILL BE RETAINED BY THE SUPPLEMENTAL FUND WHICH WILL ENHANCE THE CORPUS OF THE SUPPLEMENTAL FUND ITSELF.

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AN ADDITIONAL METHOD TO CAPITALIZE THE SUPPLEMENTAL FUND COULD BE TO ASSESS A PREMIUM ON LOANS MADE PURSUANT TO THE EXPANDED STATE AUTHORITY SIMILAR TO THAT DEVELOPED FOR MORTGAGE LOANS. IF THE LOAN TO VALUE RATIO IS GREATER THAN 80% THEN THE BORROWER MUST PAY A MARGINALLY HIGHER RATE OF INTEREST THAN WOULD BE REQUIRED IF THE LOAN TO VALUE RATIO WERE 80% OR LESS. THIS ADDITIONAL INTEREST ASSESSMENT WOULD BE APPLIED TO THE SUPPLEMENTAL FUND FOR THE LIFE OF THE LOAN. ATTACHED HERETO AS EXHIBIT III ARE MANAGEMENT GUIDELINES PERTAINING TO THE TEXAS SUPPLEMENTAL FUND.

THE SUPPLEMENTAL FUND CONCEPT PROVIDES PROTECTION TO THE FSLIC IN THE FORM OF INDEMNIFICATION OF THE ADDITIONAL RISK ASSUMED BY A MEMBER ASSOCIATION. THE SUPPLEMENTAL FUND WILL PROMOTE SELF DISCIPLINE WITHIN THE SAVINGS AND LOAN INDUSTRY. MEMBER ASSOCIATIONS ARE REQUIRED TO ASSUME A LEVEL OF THE RISK INCURRED BY OTHER MEMBER ASSOCIATIONS. I VENTURE TO SAY A SELF MONITORING SYSTEM WOULD SOON FALL INTO PLACE. NASS&LS BELIEVES THAT THE CONCEPT OF STATE SPONSORED SUPPLEMENTAL FUNDS IS A VIABLE RESPONSE TO THE PRESENT CIRCUMSTANCES AND WORTHY OF ANALYSIS AND DISCUSSION BY THIS DISTINGUISHED COMMITTEE.

NASS&LS AND OTHERS BELIEVE THAT ONE POSSIBLE COURSE OF ACTION IN DEALING WITH THE PROBLEM THAT EXISTS TODAY MAY BE THAT OF TRANFERRING THE APPROXIMATELY $4 BILLION OF EXCESS NET WORTH FROM THE FEDERAL HOME LOAN BANK SYSTEM TO THE FSLIC. THIS ADDED CAPITAL COULD BE USED TO BUY, DIRECTLY OR VIA LEVERGING, A PORTION OF THE BAD LOANS PRESENTLY IN THE SYSTEM AND POSSIBLY REFINANCE THESE LOANS OR DISTRIBUTE THE LOANS THROUGHOUT THE SAVINGS AND LOAN INDUSTRY. ADDITIONALLY, THE FSLIC COULD SELL THE CHARTERS IT WOULD THEN OWN TO OUTSIDE INVESTORS WITH TANGIBLE CAPITAL TO INFUSE INTO THE SYSTEM. THIS SCENARIO IS SOMEWHAT BASED UPON THE ASSUMPTION UNITED WE STAND DIVIDED WE FALL. ONE POINT WHICH HAS PREVIOUSLY BEEN BROUGHT TO THE ATTENTION OF THIS COMMITTEE DURING THE COURSE OF THESE HEARINGS IS THAT WHEN ANY FINANCIAL INSTITUTION REACHES ZERO TANGIBLE NET WORTH ANY CONTINUED LOSSES WILL ONLY CREATE A HOLE WHICH WILL BE DIFFICULT TO EXTRICATE OURSELVES FROM. ONE NEED ONLY LOOK AT THE LEVEL OF INSOLVENT SAVINGS AND LOANS AGAINST THE FSLIC RESERVES TO SEE AN ILLUSTRATION OF THIS POINT. IN SHORT, THE REGULATORY AUTHORITIES OF THIS COUNTRY, BOTH FEDERAL AND STATE, MUST BE GIVEN THE POWERS AND EXPRESSLY INSTRUCTED BY THIS CONGRESS TO

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ACT MUCH MORE QUICKLY THAN HAS HISTORICALLY BEEN THE CASE WHEN CONFRONTED WITH A FAILING INSTITUTION. AS STATED BEFORE, THE AMERICAN CONSUMER'S BEST INTEREST MUST BE PARAMOUNT TO ALL OTHER CONCERNS. THE BIDDING PROCESS AND OTHER BUILT IN IMPEDIMENTS TO AN EXPEDITED RESOLUTION OF A PROBLEM SITUATION MUST BE MODIFIED SO AS TO INSURE A PROMPT RESOLUTION OF THESE PROBLEMS. LIKE A WOUND, DELAY WILL ONLY AGGRAVATE THE PROBLEM.

CONCLUSION

MR. CHAIRMAN AND DISTINGUISHED MEMBERS OF THE COMMITTEE, THE NATIONAL ASSOCIATION OF STATE SAVINGS AND LOAN SUPERVISORS COMES BEFORE YOU TODAY OFFERING ITS THOUGHTS ON THE VERY COMPLEX ISSUES AT HAND. WE OFFER POSSIBLE COURSES OF ACTION, SOME BEING ATTEMPTED AND SOME MERELY CONCEPTS. WE DO NOT OFFER ANY CURE ALL, BUT ONLY WHAT NASS&LS BELIEVES MIGHT BE SOME POSITIVE STEPS TO HELP THE SAVINGS AND LOAN INDUSTRY REGAIN THE STRENGTH WHICH IT SO DESPERATELY NEEDS. THE SAVINGS AND LOAN INDUSTRY ON THE WHOLE NEEDS TO RETURN TO A BASIC DEFINITION OF WHAT CONSTITUTES NET WORTH AND WE BELIEVE IT SHOULD BE TANGIBLE NET WORTH. ONCE CONGRESS HAS DETERMINED THE DEFINITIONS AND GUIDELINES UNDER WHICH THE SAVINGS AND LOAN INDUSTRY IS TO FUNCTION THEN, AND ONLY THEN, CAN IT BEGIN TO EMBARK ON A SUSTAINED RECOVERY. WE BELIEVE THAT THESE ENDS CAN BE ACCOMPLISHED THROUGH PROPER MONITORING AND EXAMINATION AND SUPERVISION, BOTH ON THE STATE AND FEDERAL LEVEL, AND THE ORDERLY INCREASE IN THE NET WORTH OF THE SAVINGS AND LOAN INDUSTRY.

THANK YOU FOR THIS OPPORTUNITY TO EXPRESS NASS&LS' POSITION ON THESE EXTREMELY IMPORTANT ISSUES. WE LOOK FORWARD TO WORKING IN HARMONY WITH YOU AND YOUR STAFF AS YOU ENDEAVOR TO CRAFT AN APPROPRIATE LEGISLATIVE RESPONSE TO DEAL WITH THESE COMPLEX ISSUES. I LOOK FORWARD TO RESPONDING TO ANY QUESTIONS WHICH YOU MIGHT HAVE CONCERNING NASS&LS' OPINIONS.

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KAPLAN SMITH

EXHIBIT I

TEXAS DEPARTMENT OF SAVINGS AND LOANS

FINANCIAL PERFORMANCE MONITORING SYSTEM

USER DOCUMENTATION

February 13, 1985

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TEXAS DEPARTMENT OF SAVINGS AND LOANS
FINANCIAL PERFORMANCE MONITORING SYSTEM
USER DOCUMENTATION

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TEXAS DEPARTMENT OF SAVINGS AND LOANS
FINANCIAL PERFORMANCE MONITORING SYSTEM
USER DOCUMENTATION

I. INTRODUCTION

Kaplan Smith & Associates, Inc. ("Kaplan Smith") has developed a complete in-house database and information system based on the new Federal Home Loan Bank Board ("FHLBB") Quarterly Report. Standard reports, using both balance sheet and ratio formats, can be produced (1) for any institution reporting to the FHLBB, (2) for standard aggregates compiled by Kaplan Smith, and (3) for any combination of two or more institutions.

1.1 Sources of Data

The foundation of the quarterly system is a database that consists of historical financial data for every federally-insured savings institution (S&Ls and some savings banks) in the United States. Each institution is required to file a periodic standard report with the Federal Home Loan Bank Board. Kaplan Smith receives all "public" information from the Quarterly Reports that is released under the Freedom of Information Act. This information is distributed on magnetic tape following the end of each reporting period.

Effective March 31, 1984, the reporting interval changed from a semi-annual frequency to the current quarterly system. This change in reporting frequency was accompanied by extensive changes in format. In order to maintain a valid time series of financial data, Kaplan Smith has adjusted the line items reported on the past semi-annual reports to flow accurately into the quarterly report line items.

1.2 Reporting Dates and Availability of Data

The Quarterly Report for each institution in the U.S. is released by the FHLBB on magnetic tape approximately four months after the end of the reporting period. For example, for the period ending June 30, 1984, the tape will be received around the end of October, 1984. Kaplan Smith then processes the information for mergers and calculates standard aggregates. Approximately one month after the tape is received, the data are available for generating reports for consulting projects.

1.3 Adding or Revising Data

Because timeliness of data is so important, Kaplan Smith has developed a method for entering data directly from an institution's hardcopy quarterly report for more recent quarters. For example, if the latest data available from the FHLBB tape are as of March 31 and the June 30 data will not be available until late October, an association can forward its June 30 report to Kaplan Smith anytime after June 30 and receive immediate processing of that

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information. However, when the new FHLBB tape is received, the tape's "official" data will replace the manually-entered data to preserve the information in the form sent to the FHLBB.

Occasionally, data reported to the FHLBB are found to be erroneous or have been updated by the institution at a later date. While Kaplan Smith maintains only the FHLBB official data on a permanent basis, it is possible to create a temporary record for any institution or merged entity and edit the data to generate corrected results. (This procedure is described in Section V of this documentation.)

1.4 Public vs. Proprietary Data

Under the Freedom of Information Act, the FHLBB is allowed to release most of the Quarterly Report data to the public for individual institutions. However, some of the more sensitive data are not released.

For a specific institution, the User is able to manually enter the additional proprietary data to perform a more complete analysis of the institution's performance. There is a separate section of the database that contains this sensitive information, and which is not accessed except for projects done for the institution who submitted the information. These data are entered directly from the hardcopy Quarterly Report submitted by the institution.

Proprietary information includes the following line items:

Section A:	Line items 910, 920, and 930
Section C:	930 and 940
Section D:	900, 910, and 920
Section F:	All fields except 380, 390, 400, 410, 473, 490, 520, 530, and total of 500 and 510
Section G:	All fields
Section H:	All fields except 030, 070, 110, 150, 190, 230, 270, 310, 350, 390, 530, 570, 610, 650, 690, 730, 770, and 810
Section I:	030
Section K:	All fields.

When proprietary data are not input, the data are reported as "NA", and schedules 8, 9, and 10, which are heavily affected, are not generated by the Performance Report software.

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1.5 Generating Reports

There are two standard reports that can be generated from the quarterly system:

- A series of ten tables (the "Performance Report"), combining dollar balances and ratios to cover every aspect of an institution's financial condition and performance.

- A "Financial Statement" that reports every line item from the quarterly report, for the last seven periods. (Prior to March 31, 1984, periods are six months long, reflecting the old semi-annual reporting system.)

These standard reports can be generated by any user for the following entities:

- Any individual institution filing a quarterly report with the FHLBB.

- Any standard aggregate compiled by Kaplan Smith, including:

  For the U.S. --
  - Total U.S.
  - Asset size class
  - Charter type

  For each FHLB district --
  - District total
  - Asset size class
  - Charter type

  For each state:
  - State total
  - Charter type.

- Any combination of two or more institutions (a "merger" run).

1.6 User Documentation

The following text explains in detail the different options available in the quarterly report system, with complete procedures for generating each type of report. The topics described in the documentation include the following:

- Accessing the Financial Performance Monitoring System
- Generating a Performance Report
- Generating a Financial Statement
- The Merger Workspace
- Editing the Database.

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II: ACCESSING THE FINANCIAL MONITORING SYSTEM

All features of the Financial Monitoring System can be accessed through the initial menu on the Data General system, which is illustrated below.

2.1 Financial Monitoring System Menu

The primary menu for the system is displayed whenever the user logs on; the menu and its options are as follows:

Texas Department of Savings and Loans
Financial Monitoring System

Selection	Description
1.	Quarterly Performance Reports
2.	Quarterly Financial Statements
3.	Monthly Performance Reports
4.	Monthly Financial Statements
5.	Edit Quarterly/Monthly Information
6.	Quarterly Merge System
7.	Comprehensive Electronic Office
E.	Exit System

Option 1: Quarterly Performance Reports

This option will take you into the part of the system where you can generate the ten tables of data for a particular institution, aggregate, or merged combination of institutions. Refer to Part III of this documentation for a complete description of the required procedures.

Option 2: Quarterly Financial Statements

This option allows you to generate a full financial statement for a particular institution, aggregate, or merged entity. Refer to Part IV of this documentation for a complete set of procedures for this report.

Option 3: Monthly Performance Reports

This option will take you into the part of the system where you can generate reports from monthly data for a particular institution, aggregate, or merged combination of institutions. Refer to Part III of this documentation for a complete description of the required procedures.

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Option 3: Monthly Financial Statements

This option allows you to generate a full financial statement for a particular institution, aggregate, or merged entity. Refer to Part IV of this documentation for instructions on generating the report.

Option 5: Edit Quarterly/Monthly Information

This part of the quarterly system allows you to work with the raw data records for an institution. Briefly, you have three choices of activity at this point:

- You can display the data on the screen and/or print it.
- You can enter data for a more recent period for a particular institution for which you have hardcopy, or add proprietary data.
- You can edit historical data for an institution to correct an error or change some of the identifying fields.

The last two options have special passwords to protect the database. Refer to Part VI of this documentation for instructions for viewing or editing the data records.

Option 6: The Quarterly Merge System

This option allows you to merge two or more associations together to create a temporary record for the resulting merged entity. Following the "merger", the Performance Report and the Financial Statement can be generated for the merged entity. Refer to Part V of this documentation for complete details on how to merge two or more institutions together.

Option 7: Comprehensive Electronic Office

This option provides access to Data General's CEO (Comprehensive Electronic Office) software, which contains such features as electronic mail, filing, and word processing.

Option X: Exit System

To exit from the Financial Monitoring System, type X and press NEW LINE. You will be logged off the system.

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III: THE QUARTERLY PERFORMANCE REPORT

The Quarterly Performance Report ("Performance Report") is a set of ten tables that provide a complete series of ratios and dollar figures for a particular association, aggregate, or merged entity. All data contained in the Performance Report are reported on the Quarterly Report or are calculated from reported data.

Any user can generate one or all of the 10 tables for one institution in a single pass.

3.1 Database Selection Screen Menu

Select option #1 from the Financial Monitoring System Menu to generate a Performance Report. The Database Selection Screen menu is displayed:

```
                Financial Performance Monitoring System
                    Database Selection Screen
 ____________________________________________________________


          Full Quarterly Database.....................(1)
          Merger Workspace............................(2)

                    Enter Selection (ESC = EXIT)..... 1

          Do you want to use the Proprietary Information (YES/NL)?  YES
          Are you sure your want Proprietary Info. (YES/NL)?        YES


     Proprietary Information Available - PRESS NL
```

- Option #1 ("Full Quarterly Database") generates the Performance Report for an individual association or a standard aggregate.

- Option #2 ("Merger Workspace") allows you to generate the Report for a merger record created earlier. Refer to Part V for complete instructions on how to create a merged record.

- Do you want to use the Proprietary Information (YES/NL)? NO

  As noted earlier, users have the option of manually entering "proprietary data" from a hardcopy quarterly report. These sensitive data are not released by the FHLBB on the quarterly report tape.

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Once the data are entered in the system, they can be included in the Performance Reports. However, due to the confidential nature of this information, the user must choose whether to include it in a report.

When proprietary data are included in a report, there is a notation in the upper right corner of each page indicating that "Association Data" (rather than "FHLBB Data") are present. When proprietary data are not included, the affected data fields are filled with "NA", and Schedules 8, 9, and 10, which are heavily dependent on proprietary data, are not generated.

Press NEW LINE to select Option #1. The Basic Information menu appears:

```
                    Financial Performance Monitoring Report
                              Basic Information


Docket: _____  Suffix: 0000000  Merged:
District:    State FIPS:    County FIPS:      CMSA Code:     PMSA Code:
Association Type:    Asset Class:

Name:
Address:
City:
State:
County:
CMSA Name:
PMSA Name:
State Abbr:
Zip Code:

Latest Year:
Latest Quarter:
Membership Date:    /  /
Insurance Date:     /  /
Closing Month:

ENTER Docket and Suffix or Name.  ESC=EXIT
```

3.2 Select the Desired Association or Aggregate

- To select an individual association, either input the five-digit docket number for the desired association in the "Docket" field or use the NEW LINE key to move down to the "Name" field and enter the first few letters of the institution name. If you have created a merged association, you can enter its docket number or name at this point, as long as you elected to use the "Merger Workspace" when entering the system.

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- Any four-digit docket number must be preceded by a zero. For example, Vernon Savings' docket number is 6485, so you must enter 06485.

- To select a standard aggregate, there are two methods to choose from:

1. Input 99999 in the docket field. This code tells the system that you are asking for an aggregate instead of an individual association. In the "suffix" field, enter the suffix code for the desired aggregate. Do not press NEW LINE to register the numbers, as the system accepts the data as soon as the field is complete.

OR

2. Move down to the "Name" field and enter the first few letters of the aggregate name (e.g., enter TEX to obtain the state total for Texas).

If you have entered a valid docket number or name, the "basic information" for the association or aggregate will appear to confirm your selection. The information for Vernon Savings would appear as follows:

Financial Performance Monitoring Report
Basic Information

Docket: 06485 Suffix: 0000000 Merged: 0
District: 09 State FIPS: 48 County FIPS: 487 CMSA Code: 00 PMSA Code: 0000
Association Type: 03 Asset Class: 08

Name:	VERNON SAVINGS
Address:	1725 WILBARGER ST
City:	VERNON
State:	TEXAS
County:	WILBARGER
CMSA Name:	NON CMSA
PMSA Name:	NON PMSA
State Abbr:	TX
Zip Code:	76384-0000
Latest Year:	84
Latest Quarter:	4
Membership Date:	09/00/60
Insurance Date:	09/21/60
Closing Month:	06

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The next option can be selected from the choices at the bottom of the screen. Press the appropriate blank function key to select the desired activity. The choices are:

- F1 function key to move backward in the database to the preceding docket or association name.
- F2 function key to move forward in the database to the next docket or association name.
- F3 function key to generate the Performance Report for the selected association.
- F4 function key to select a different docket or name.
- Press the BREAK ESCape key to exit from this part of the program.

3.3 Generate the Performance Report

To generate the schedules for the selected docket, press the F3 function key. The "Report Selection Screen" is displayed as follows:

```
                    Report Selection Screen

     Docket: 06485  Suffix: 0000000  Name:  VERNON SAVINGS

       Year of Report:  1984  Current Quarter of Report: 4  (1,2,3,4)

Schedules Desired (Y/n1):  ALL  1  2  3  4  5  6  7  8  9 Cap Sum
                            Y   Y  Y  Y  Y  Y  Y  Y  Y  Y  Y   Y

Information Correct? (Y/n1):  Y
```

The required input items are:

- Year of Report. Enter the last two digits of the latest year for which you want data. The default is the current year. You do not need to press NEW LINE to register new input.
- Current Quarter of Report. Enter the last calendar quarter you want to see on the report. The default is the last quarter for which the FHLBB tape has been processed. However, if you have manually entered more recent data, enter the number for the appropriate quarter (1, 2, 3, or 4).

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- Schedules Desired. Here you must enter a "Y" if you want a particular schedule, or press NEW LINE to skip that option. If you enter a "Y" under "ALL", you will automatically receive all ten schedules and the cursor will not ask you to select the individual schedules. However, for example, if you just want Schedule 1, you must press NEW LINE to move under "1", enter "Y", then continue to press NEW LINE for all other schedules.

  The last two schedules (denoted as "Gap" and "Sum") refer, respectively, to tables on interest rate sensitivity and a summary table indicating the association's rating according to the FHLBB's "triggers and flags" monitoring system. The "Gap" table requires additional input, as denoted in Section 3.3.1 below.

- Information Correct? If you're satisfied with your choice of schedules, type "Y". Otherwise, press NEW LINE and the cursor will move back up to the previous step.

- If you elected to generate the "Gap" reports, you will see another menu, shown below, where you can fill in various prepayment assumptions and other information. To accept the "default" answers, press the BREAK ESCape key to exit from the table.

When the requested schedules have been compiled, the cursor returns to the Basic Information menu, where you can select another association. If you do not want to select another association, press the BREAK ESCape key.

3.3.1 GAP Report Assumptions

If you have entered proprietary data from Section H of the Quarterly Report, Schedule 10 will contain the detailed information regarding the maturities of assets and liabilities. You have the option of entering certain prepayment assumptions that will be applied to the data, by completing the GAP Report Assumptions tables.

Kaplan, Smith enters prepayment assumptions for the United States and for each FHLB District as they become available. In Part 1 of the GAP Report Assumptions menu, indicate which prepayment assumptions you will use by entering:

- 1 to use the FHLB District figures (if available)
- 2 to use the U.S. figures (if available)
- 3 to elect not to use any assumptions.

You can also enter any figures you wish to replace those given in the tables. The two menus are illustrated on the following page.

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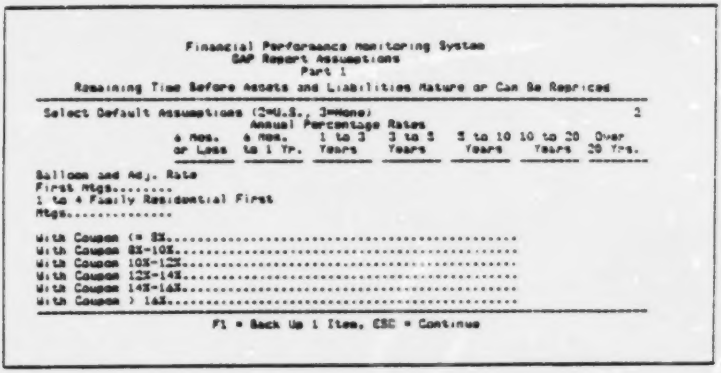


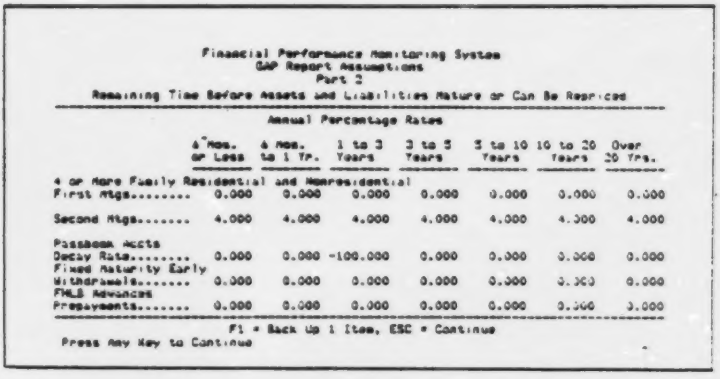
Financial Performance Monitoring System
GAP Report Assumptions
Part 1

Remaining Time Before Assets and Liabilities Mature or Can Be Repriced

Select Default Assumptions (2=U.S., 3=None): 2

	Annual Percentage Rates						
	6 Mos. or Less	6 Mos. to 1 Yr.	1 to 3 Years	3 to 5 Years	5 to 10 Years	10 to 20 Years	Over 20 Yrs.
Balloon and Adj. Rate First Mtgs.....							
1 to 4 Family Residential First Mtgs.....							
With Coupon (= 8%.....							
With Coupon 8%-10%.....							
With Coupon 10%-12%.....							
With Coupon 12%-14%.....							
With Coupon 14%-16%.....							
With Coupon > 16%.....							

F1 = Back Up 1 Item, ESC = Continue



Financial Performance Monitoring System
GAP Report Assumptions
Part 2

Remaining Time Before Assets and Liabilities Mature or Can Be Repriced

	Annual Percentage Rates						
	6 Mos. or Less	6 Mos. to 1 Yr.	1 to 3 Years	3 to 5 Years	5 to 10 Years	10 to 20 Years	Over 20 Yrs.
4 or More Family Residential and Nonresidential First Mtgs.....	0.000	0.000	0.000	0.000	0.000	0.000	0.000
Second Mtgs.....	4.000	4.000	4.000	4.000	4.000	4.000	4.000
Passbook Accts Decay Rate.....	0.000	0.000	-100.000	0.000	0.000	0.000	0.000
Fixed Maturity Early Withdrawals.....	0.000	0.000	0.000	0.000	0.000	0.000	0.000
FHLB Advances Prepayments.....	0.000	0.000	0.000	0.000	0.000	0.000	0.000

F1 = Back Up 1 Item, ESC = Continue

Press Any Key to Continue

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3.4 View or Print the Output

- "Do you wish to view the output on the screen? Y/NL." If you not want to display the report on the screen, just press NEW LINE. If you do wish to display the output, type Y and NEW LINE.

  The reports will be displayed in "compressed" mode, so that all data will fit on the screen. When you exit from the display, the screen will revert to the normal display mode.

- "The file QTS10 contains your output for editing." The output file that contains the Performance Reports just generated is always named QTS10.

- "Do you want hardcopy printout? Y/NL" If you want to print the output file, type Y and NEW LINE. Otherwise, just press NEW LINE.

3.5 Performance Report for Merged Associations

It is possible to generate the Performance Reports for any combination of one or more associations. However, you must first have created the merged record. The merger process is described in detail in Part V of this documentation. After the merger record is created, follow the standard procedures for generating the Performance Reports, beginning with Section 3.1 by selecting option #2 to access the merger database.

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IV: THE QUARTERLY FINANCIAL STATEMENT

A full financial statement can be generated for any institution, standard aggregate, or merged entity. This financial statement provides seven periods of data for each line on the quarterly report. You can print the entire statement or just selected sections. The report contains a maximum of 22 pages when all sections are run.

The "public" tape from the FHLBB does not contain the proprietary sensitive data reported by the associations. However, Kaplan Smith has the capability of manually entering these data from hardcopy reports received from a client, and printing the data as part of the financial statement. If this "private" information is not available for a particular association, then some line items or entire sections will print as "NA" — not available.

4.1 Financial Statement Report Screen

To generate a financial statement, select option #2 ("Quarterly Financial Statements") from the Financial Monitoring System menu. The Database Selection Screen menu is displayed as shown in Section 3.1 of this documentation. Select the appropriate options from that menu, including whether you will use proprietary information for the institution. The Financial Statement Report Screen is then displayed:

```
                    Financial Performance Monitoring System
                      Financial Statement Report Screen

Docket: _____  Suffix:                  Current Year:      Current Qtr:
Name:                                   Number of previous periods to list:
==========================================================================
                        Basic Institution Information
==========================================================================

     Name:                                          Docket:

     Street:
     City:
     County:
     State:                                 Zip:

     CMSA:
     PMSA:

     ----------------------Miscellaneous Information-----------------------

     State FIPS:      County FIPS:      Association Type:      Close Month:
```

4.2 Select the Desired Association or Aggregate

There are several input fields that must be completed:

- Enter the docket and suffix for the desired association or aggregate, or move down to the name field and type the first few letters of the name.

  Docket. Enter the five-digit docket number for the desired association. For a standard aggregate, enter 99999. (For a merged record, you must select the merger workspace from the Database Selection Menu.)

  - You do not need to press NEW LINE to register the number.

  - Any four-digit docket number must be preceded by a zero.

  - Suffix. If you entered a docket number of 99999 to select a standard aggregate, you must complete the suffix field to indicate which aggregate should be generated.

- Confirm choices. As instructed at the bottom of the screen, if the displayed institution is correct, press NEW LINE. Otherwise, type N and the cursor will return to the docket field so you can enter the correct docket number.

- Current Year. Enter the last two digits of the latest year for which you want data to be generated. The default is the current year. You do not need to press NEW LINE to register the input.

- Current Quarter. Enter the last calendar quarter you want to see on the report. The default is the last quarter for which the FHLBB tape has been processed. However, if you have manually entered more recent data, enter the number for the appropriate quarter (1, 2, 3, or 4).

- Number of previous periods to list. The maximum number of periods that will print on one page is seven; that is the default answer. Press NEW LINE.

  If you need more than seven periods, you can generate the financial statement again, changing the current year and current quarter information to give you the missing periods.

- Confirm choices. If the year and quarter are correct, press NEW LINE. Otherwise, type N and the cursor will go back to the year field so you can enter the correct information.

The completed Report Screen Menu will appear as follows, using Vernon Savings as an example:

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```
                    Financial Performance Monitoring System
                      Financial Statement Report Screen

Docket: 06485   Suffix: 0000000              Current Year: 84    Current Qtr: 4
Name:                                       Number of previous periods to list: 7
********************************************************************************
                            Basic Institution Information
********************************************************************************

     Name:      VERNON SAVINGS                                  Docket: 06485

     Street:    1725 WILBARGER ST
     City:      VERNON
     County:    WILBARGER
     State:     TEXAS                                 Zip: 76384

     CMSA:      NON CMSA
     PMSA:      NON PMSA

     ------------------Miscellaneous Information-----------------------

     State FIPS: 48    County FIPS: 487  Association Type: 3   Close Month:
```

4.3 Select the Sections to be Printed

From the Financial Statement Report Selection Screen, select the sections of the Financial Statement that you want to print. The menu appears as follows:

```
                    Financial Statement Report Selection Screen

Docket:  06485
Suffix:  0000000          ALL   A  B  C  D  E  F  G  H  I  K
Sections to Print:         Y    Y  Y  Y  Y  Y  Y  Y  Y  Y  Y

Are Print Options correct?  N or M/L.

Would you like to display the Report?  Y or M/L.
```


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- Type "Y" under the heading for each section to be printed (A, B, etc.). If you want to print all sections, enter "Y" under the "ALL" heading. The quarterly report sections identified by each letter code are as follows:

  Section A: Assets
  Section B: Liabilities
  Section C: Regulatory Net Worth
  Section D: Income
  Section E: Expense
  Section F: Supplemental Data
  Section G: Deposit Balances
  Section H: Maturity and Yield/Cost Data
  Section I: Annual Supplement
  Section K: Slow Loans and Scheduled Items.

- Confirm choices. As instructed at the bottom of the screen, if the sections are correct, press NEW LINE. If they are not correct, type N and enter the correct data.

- "Do you want the Report displayed?" If you plan to view the output on the screen, enter Y. The output will be displayed in "compressed" mode so that the entire report will fit on the screen. When you exit from the display, the screen will revert to normal width.

  If you do not want to display the output, press NEW LINE. The Report Selection Screen menu will be displayed again. If you do not wish to select another association, press BREAK ESCape.

- "Do you wish to view/edit the output? Y/NL" If you want to make some changes to the output, you can edit the file.

- "The file FINANCIAL.STMT contains your output for editing."

  This is the name of the output file for the last financial statement you generated.

- "Do you want hardcopy printout? Y/NL" Type Y to print the Financial Statement.

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V. THE MERGER WORKSPACE

The Merger Workspace feature allows any user to combine two or more associations into a single entity, then generate a Performance Report and Financial Statement for the merged association.

Select option #6 from the Financial Performance Monitoring System Menu to enter the routine to generate the merger record and assign a docket number. If you wish to run the Performance Report or Financial Statement or display the raw data for the merged records, you would return to the Financial Performance System Menu and select options 1 or 2 as you would for an individual association or standard aggregate.

5.1 Generate a Merged Association Record

Select Option #6 from the Financial Performance Monitoring System menu. The Merger Simulation Program menu is displayed as it would appear for merging Vernon Savings with, for example, Home Savings of America:

```
                    Financial Performance Monitoring System
                         Merger Simulation Program

Perform Additions to or Subtractions from New or Existing Merged Unit.....(1)
Delete Existing Merged Association.....(2)
Display Components of Existing Merged Association.....(3)
Display All Merged Associations.....(4)
                                   Enter Choice.....1

Enter Merged Docket (00000-90000):  06485
Enter Merged Association Name: VERNON + HOME SAVINGS OF AMERICA
Merge through 1984 Qtr:3 Retention Period in Days (0-99) 30  Exp. Date 03/10/85

Docket: 06485 Suffix: 0000000 Name:  VERNON SAVINGS

                                   City:  VERNON
                                   State: TEXAS
Add to Merged Docket          (Y/NL): Y
Subtract from Merged Docket   (Y/NL): N
```

In the first part of the menu, you must select the operation you want to perform on the merger database:

1. "Perform Additions to or Subtractions from New or Existing Merged Unit." Type 1 to select this option, which you would use to:

   - create a new merged association

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- add one or more associations to an existing merged association

- subtract one or more associations from an existing merged association.

To create a new merged unit:

- "Enter Merged Docket (00000-90000):" Because the merger database is separate from the regular quarterly database, you can assign any docket number to a merged institution. Enter a new five-digit docket number here.

- "Enter Merged Association Name:" Type in a concise name for the merged entity. You can include more than one word, with spaces and special characters.

- "Merge through 19__ Qtr:_" Enter the latest year and quarter for which you want the association records to be merged. NOTE: If any of the merged associations has later information than the others due to manual updates, that information will be noted when you select option #3 from the Merger Simulation Program menu.

- "Retention Period in Days (0-99)" The default number is 30. This tells the system how many days you want the merged record to be retained. The "Expiration Date" is calculated and displayed. Press NEW LINE to accept the information.

- "Docket:" Fill in the five-digit docket number for the first association to be included in the merged entity. If the association is an aggregate (with a docket number of 99999, fill in the suffix to denote which aggregate you want to include (or enter the aggregate's name instead of the docket/suffix codes).

  The name of the association or aggregate will be displayed to verify the docket number.

- "Add to Merged Docket (Y/NL):" To accept that association and have it added to the merged entity, type Y. If you change your mind or the docket number was incorrect, type N or NEW LINE.

- "Subtract from Merged Docket (Y/NL):" To delete an association from the merged entity, type Y. If you do not want to delete the association, type N or NEW LINE.

- The cursor moves back up to the docket field. If you want to add additional associations to the merged entity, enter the docket number of the next association to be added. Or, to delete an association from the merged unit, enter its docket here and answer Y to the last prompt ("subtract...").

- To list the associations included in the merged entity, press BREAK ESCape to move the cursor back up to the top of the menu and select option #3 (described below).

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- To generate the Performance Reports or Financial Statement, use the BREAK ESCape key to go back to the Financial Performance Monitoring System menu and select the appropriate option at that point. From the Database Selection Menu, be sure to choose option #2 (Merger Database).

5.2 Delete Existing Merged Association

If you no longer have need of a merged association, or if you made an error in creating the merger, you can delete the merged association. To do so:

- In the top section of the Merger Simulation Program menu, select option #2 ("Delete Existing Merged Association").

- Enter the docket number of the merged entity to be deleted.

- Type Y in response to the request for confirmation.

NOTE: This option is used to delete an entire merged entity. To delete (or "subtract") one or more of the individual associations from a merged unit, use option #1, as described in the previous section.

5.3 Display Components of Existing Merged Association

To list the associations within a particular merged entity:

- In the top section of the Merger Simulation Program menu, select option #3 ("Display Components...").

- Enter the docket of the merged entity

The list of associations that make up the merged unit is displayed as follows, continuing the example given above:

```
06485 VERNON + HOME SAVINGS OF AMERICA    Merged thru 84:4   02/13/85

01914 0000000 HOME-AMERICA-LOS ANGELES      LOS ANGELES          N.A.
06485 0000000 VERNON SAVINGS                VERNON               909


  End of Components - PRESS RL
```

The last column contains total assets for the latest period included in the merger. In this case, note that Vernon Savings had data for a later period than was available for Home Savings. This situation occurred because recent quarterly data was manually entered for Vernon Savings but not for Home. This information suggests that the user should limit the Performance Reports and quarterly

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Financial Statement to the last period for which the FHLBB tape has been processed. Otherwise, the data appearing for the last period will contain data only for, in this case, Vernon Savings. Press NEW LINE to exit from the list of associations.

5.4 To Generate Performance Reports

To run the Performance Reports for any merged entity, select option #1 from the Quarterly Financial System menu (the initial menu for the quarterly system).

From the Database Selection Menu, select #2 ("Merger Database").

Proceed from that point as you would normally complete the menu for Performance Reports for any association.

5.5 To Generate the Quarterly Financial Statement

To run a Financial Statement report for any merged entity, select option #2 from the Financial Performance Monitoring System menu.

From the Database Selection Menu, select #2 ("Merger Workspace").

Proceed from that point as you would normally complete the menu for the Financial Statement for any association.

5.6 To Edit the Merged Records

You can edit the data for a merged association or change historical data for an individual association by working with the merger workspace and the editing procedures described in Part VI of this documentation.

Refer to Section 5.1 for procedures on creating a merged association record. Then, proceed to Part VI to edit the data.

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VI: EDIT QUARTERLY/MONTHLY INFORMATION

The System has a feature whereby a user can make changes or additions to the database. These changes will be maintained separately from the "official" FHLBB data to preserve the original information permanently. However, the dual nature of the databases will not be apparent to the user, who will merely have to make a selection from a menu to access the desired information.

6.1 Access Codes

The editing feature contains three levels of database security to protect the permanent data while allowing changes or additions to be made. Anyone can view a record; however, there are separate passwords that must be used to enter a new period's data or to change historical data or descriptive information.

Select option #5 from the Financial Performance Monitoring System menu to access the system's editing features. The following menu is displayed:

```
                Financial Performance Monitoring System
                     Identification Verification


                              Access Code:

                              Database Selection

                    Full Quarterly Database.....(1)
                    Merger Workspace............(2)

                         Enter Selection (ESC = EXIT)..... 1

    Enter Access Code.  ESC=EXIT
```

6.1.1 Using the Proper Access Code

In the "Identification Verification" part of the menu, the access code field is blank and requires one of two entries:

- If you just want to view the data, press NEW LINE.
- To edit the data, enter the access code for the desired activity:
  - Add a new quarter's data from hardcopy or add or edit proprietary data.
  - Make changes to the descriptive ("basic") information such as name of association, address, etc.
  - Make changes to historical data.

There is a different access code for each of the three activities. The passwords should be changed regularly and given out on a need-to-know basis. If you will be doing some editing work, contact the appropriate party in your office for the latest access code. Editing of historical data should be restricted.

After entering the access code (or not), press NEW LINE. A message at the bottom of the screen indicates your "privilege level" for this session. Press NEW LINE to continue. The Basic Information menu will be displayed, as described below.

A privilege level of 0 indicates that you will not be allowed to edit, and may only view the data.

Privilege level 1 allows you to enter data for a new period or to add or change proprietary data.

Privilege level 2 allows you to change an association's "basic information" (name, address, etc.) and to set up a new association that did not exist on the most recent FHLBB tape.

Privilege level 3 allows you to change past data. The access code for this function should be restricted to prevent errors in the permanent database.

Options available in subsequent menus depend on the privilege level.

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6.2 Selecting the Association Docket

After you have entered a password and/or NEW LINE, the Basic Information menu is displayed, as illustrated in Section 3.1.

Enter the five-digit docket number or name of the desired association. (A four-digit docket number must be preceded by a zero).

Select the option at the bottom of the screen that performs the desired function:

- F1 function key — "View Detail" allows you to view the raw quarterly report data for each line item for a particular quarter and section.
- F2 function key — displays the next docket or association name.
- F3 function key — displays the previous docket or association name.
- F4 function key — allows you to edit the Basic Information screen.

6.3 Viewing the Data Record

Viewing the data items in an association's quarterly report record is the only option available if you did not enter a password. However, this "viewing" option is available at all other security levels.

To view the data:

1. Press the F1 function key.
2. On the "Detail Information" menu, enter:
   a. the last two digits of the appropriate calendar year
   b. the quarter you wish to view
   c. the section of the report you wish to view (A, B, ..., K).

The following menu illustrates the display of data for Section A for the third quarter of 1984, for docket 06485 (Vernon Savings). Since each section of the quarterly report has different line items, some screens will display more information than others.

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```
          Financial Performance Monitoring System     EDIT MODE
                      Detail Information
Docket: 06485 Suffix: 0000000 Year: 84 Quarter: 3 Section: A merge
010:       138|200:       165|390:       542|580:     15323|
020:    100656|210:       936|400:         0|590:         0|
030:    312107|220:         0|410:     11455|800:    800981|
040:    308643|230:         0|420:         0|900:     75688|
050:     76677|240:         0|430:         0|910:         0
060:         3|250:         0|440:      4651|920:         0|
070:         0|260:      1993|450:         0|930:    586433|
080:         0|270:         0|460:         0|940:         7|
090:     22552|280:        28|470:         0|    :        |
100:         0|290:         0|480:         0|    :        |
110:    235892|300:     52119|490:     46483|    :        |
120:      9862|310:       265|500:         0|    :        |
130:         0|320:         0|510:       570|    :        |
140:    575022|330:         0|520:         0|    :        |
150:     30416|340:      9723|530:         0|    :        |
160:     16310|350:         0|540:      8221|    :        |
170:      2113|360:     14988|550:         0|    :        |
180:       214|370:     16419|560:         0|    :        |
190:         0|380:     45230|570:         0|    :        |
F5=Update. F6/F7=Scroll. F8=Verify. F9=Back step. ESC=Return to VIEW
```

The record shows the quarterly report line numbers and the value given in the database. No line titles are shown, since this is just a display of the raw data.

The options at the bottom of the screen allow the following activities:

- F2 function key — view the next quarter for that section.
- F3 function key — view the previous quarter for that section.
- F4 function key — edit the data if you have entered the proper password.
- F6 and F7 function keys — scroll the screen down or up to see the rest of the section if it takes more than one screen (only Section H requires this action).
- ESC — use the BREAK ESCape key to exit to the previous menu.

The Detail Information menu is the first phase of the editing mode as well. If you entered an editing password earlier, press the F4 function key to enter Edit mode from this point.

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6.4 Entering Data for a New Quarter

If you want to enter data for a new quarter to update the database since the last FHLBB tape, you will need to enter the values for each line item in all the sections. If you have hardcopy from the client that contains proprietary information not given on the FHLBB tape, that data can also be entered through this option.

Note: During a data entry session, you must enter data for a full section. If you enter only a partial section of data from the quarterly report, the data cannot be "verified" by the system, and will not be saved. "Verification" is explained below.

To enter data for a new quarter:

1. From the Basic Information menu, press the F1 function key ("View Detail") to access the appropriate editing menu.

2. A blank Detail Information menu will be displayed. Enter the last two digits of the year you want (e.g., 84).

3. Enter the number of the calendar quarter for which information will be entered.

4. Enter the letter for the section of the quarterly report to be input (A, B, ..., K). Press NEW LINE.

An input menu is displayed, listing each of the line item codes applicable for the chosen section, with the values given as "N/A". The following menu illustrates the form for Section A. The options at the bottom of the screen remain the same.

```
                                  . KSA Quarterly System  VIEW MODE
                                    Detail Information

Docket: 01914 Suffix: 0000000 Year: 84 Quarter: 2 Section: A Merged: 0
010:    N/A   |200:    N/A   |390:    N/A   |580:    N/A   |       :
020:    N/A   |210:    N/A   |400:    N/A   |590:    N/A   |       :
030:    N/A   |220:    N/A   |410:    N/A   |600:    N/A   |       :
040:    N/A   |230:    N/A   |420:    N/A   |900:    N/A   |       :
050:    N/A   |240:    N/A   |430:    N/A   |910:    N/A   |       :
060:    N/A   |250:    N/A   |440:    N/A   |920:    N/A   |       :
070:    N/A   |260:    N/A   |450:    N/A   |930:    N/A   |       :
080:    N/A   |270:    N/A   |460:    N/A   |940:    N/A   |       :
090:    N/A   |280:    N/A   |470:    N/A   |       :       |       :
100:    N/A   |290:    N/A   |480:    N/A   |       :       |       :
110:    N/A   |300:    N/A   |490:    N/A   |       :       |       :
120:    N/A   |310:    N/A   |500:    N/A   |       :       |       :
130:    N/A   |320:    N/A   |510:    N/A   |       :       |       :
140:    N/A   |330:    N/A   |520:    N/A   |       :       |       :
150:    N/A   |340:    N/A   |530:    N/A   |       :       |       :
160:    N/A   |350:    N/A   |540:    N/A   |       :       |       :
170:    N/A   |360:    N/A   |550:    N/A   |       :       |       :
180:    N/A   |370:    N/A   |560:    N/A   |       :       |       :
190:    N/A   |380:    N/A   |570:    N/A   |       :       |       :
ENTER data/section. F1=next. F3=Previous.F4=EDIT. F6/F7=SCROLL. ESC=Ex
```


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5. Press the F4 function key ("Edit") to move the cursor to the first line item.

You are now in Edit mode. Most of the options at the bottom of the screen are different in Edit mode:

- F5 function key — used to update the database with the newly entered data, after verification is completed.
- F6 and F7 function keys — allows you to scroll the screen up or down. Used only for Section H, where more than one screen is needed to hold the data.
- F8 function key — verify the data before adding it to the database. See "verification" below.
- F9 function key — used to "backstep" one line item at a time, in case corrections are needed.

6. For each line item:
   a. Type the data. Do not use commas. Do not use decimal points. When there is a percentage figure to be entered (e.g., 7.50 or 7.5), input it as 750. That is, include two decimal places, but do not type the decimal point. Negative numbers should be preceded with a hyphen (-) to denote a minus sign.
   b. In most cases, there will be some dashes (———) after the number. Press the ERASE EOL key to eliminate those dashes.
   c. Press NEW LINE to move to the next line item.
7. Complete all line items in the section. All "N/As" must be replaced with valid numbers; use zero if the field was left blank on the form.
8. Press the F8 function key to "verify" the data. This function is described below. If this is not done, the data for that section will not be saved.
9. After verification is complete for that section, press the F5 function key to "update" the database. This saves the new data or revisions that you entered in this section during this edit session.
10. After the "update", the cursor returns to the position where you can enter a new section code. Either type the appropriate letter or press BREAK ESCape to exit from the Edit mode.

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6.4.1 Verification

After the numbers for any section of the quarterly report have been entered in the input menu, the data must be "verified" to ensure that the numbers were not entered incorrectly, either on the hardcopy report or during data entry.

There is a built-in verification process in the quarterly system that performs totalling and other control checks on the data within each section. The verification process must be performed before applying the new data to the permanent database.

If you leave "N/A" for any line item, you will get an error message indicating that you must overwrite all N/As on the screen.

You should view the verification screen(s) for each section to make sure that the numbers have totalled properly. If there are multiple tests for a given section, you can view the screen for each test.

The display for a successful verification of Test 1 is as follows:

```
            Financial Performance Monitoring System     VERIFY MODE
                  Detail Verification Screen

Docket: 06485  Suffix: 0000000  Merged: 0  Year: 84  Quarter: 2    Test: __

     TEST 1 A1

     SUM(A010 --> A100) - SUM(A110 --> A130)

Test value is:          17989837   Percent difference is:   0.00

A140

Compare value is:       17989837   Percent difference is:   0.00

Difference is:                 0

All tests verified.  ESC=Update or ENTER test to view.
```

If all tests have been verified, the updating process described above is automatically started by pressing the BREAK ESCape key.

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6.5 Entering Proprietary Data

The procedures for entering proprietary data for past periods are generally the same as for entering data for new quarters. Follow the instructions in Section 6.4 to bring up the screen for a past period. Then:

- If the proprietary data have not yet been entered, those data fields will contain a value of "N/A". Press the F4 function key to edit the data.
- Because you are not permitted under the current access code to edit any "official" past data (i.e., any data from the FHLAB tape), the cursor will jump immediately to the first field containing proprietary data.
- Enter the data following the rules set out in Section 6.4.
- When you have finished each section, verify the input and update the database.

If you want to include proprietary data when you are entering a new quarter's data, you can enter the sensitive data in the same manner as the rest of the data.

6.6 Ending the Edit Session

When you have finished entering new data or revising data for the new quarter, press the BREAK ESCape key to exit from the menu. Continue to press that key through each of the succeeding menus, to back out of the system.

If you want to generate the Performance Reports or a Financial Statement to include the newly entered data, follow the procedures given in parts II or III of this documentation, entering the number of the most recent quarter — the one you just input into the system.

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CAPLIN & DRYSDALE
CHARTERED
WASHINGTON, D.C.

EXHIBIT II

INTRODUCTION TO LEGISLATION

In January of this year, the Federal Home Loan Bank Board ("FHLBB" or "Board") promulgated two significant new regulations designed to protect the Federal Savings and Loan Insurance Corporation ("FSLIC") from asset-quality problems that the Board believes are associated with insured institutions with large holdings of direct investments or rapid rates of growth. In particular, the Board adopted higher minimum net-worth requirements for insured institutions, and imposed new limitations on direct investments by all savings and loan associations within its jurisdiction. As a result of these new regulations, all insured institutions are now required to submit detailed business plans to the FHLBB before making such basic decisions as how fast to grow or how much to allocate to direct investments.

The Board's new regulations have serious consequences for many State-chartered associations. Due to the Board's new limitations on growth, State-chartered associations can no longer work themselves out of portfolio problems by adding new interest-rate sensitive assets. In addition, State-chartered institutions are now limited in their ability to make direct investments, which traditionally have been the most profitable of savings and loan assets. On a more intangible level, State-chartered associations find themselves hampered in their activities by having to consult with the FHLBB before making many business decisions.

The goal of this legislation is to offer State-chartered associations a way to free themselves from the more burdensome aspects of the new FHLBB regulations without creating additional risks for the FSLIC insurance fund. To be more specific, the purpose is to find an alternate method for safeguarding the FSLIC from asset-quality problems. To these ends, the sponsors of this legislation propose the creation of a voluntary system of State Supplemental Insurance Funds to insure the asset-quality of participating State-chartered associations.

The State Supplemental Insurance Funds would be financed by State-chartered associations and administered by State regulatory authorities. The Funds would protect the FSLIC insurance fund by providing a first layer of insurance on a specified portion of the assets of participating associations. To qualify for coverage by this legislation, each State Supplemental Insurance Fund would have to obtain a certification from the Federal Home Loan Bank president who supervises the State sponsoring the Fund.

In return for participating in a qualifying State Supplemental Insurance Fund, State-chartered associations would be exempt

from those portions of the FHLBB's new regulations that limit direct investments and require approval of growth by insured institutions. This exemption would free participating State-chartered associations to conduct their affairs within the limits of prudence and business judgment rules. However, due to the existence of the State Supplemental Insurance Funds, this relaxation of federal regulations would not increase the risks for the FSLIC insurance fund.

A draft of the proposed legislation is attached to this Summary, and a brief textual description of the bill is provided below.

To qualify under the proposed legislation, a State would have to establish a State Supplemental Insurance Fund and apply to the president of the local Federal Home Loan Bank for certification that the State's Supplemental Insurance Fund satisfies the following three criteria: First, the Fund must have sufficient assets to guarantee twenty percent of the assets of participating associations, up to a maximum of $50 million for each participant. Second, the State regulator charged with administering the Fund must have the legal authority to appoint a conservator to manage any participating State association that is in imminent danger of insolvency or otherwise in violation of specified standards of conduct. Third, the State regulator must have established a reasonable system for monitoring on at least a quarterly basis the financial condition of participating State associations and for examining them on at least an annual basis.

The reward for participating in a qualifying State fund would be five-fold. First, participating State associations would be permitted to invest up to forty percent of total assets in direct investments, unless applicable State regulations imposed a lower ceiling. Second, participating State associations would be exempt from the provision of the Board's new net-worth requirements that creates a contingency requirement for direct investments in excess of ten percent of assets. Third, participating State associations would be permitted to grow in excess of twenty-five percent per year without obtaining prior approval from the FHLBB. Fourth, participating State associations would be permitted to meet the FHLBB's net-worth requirement on an annual, rather than quarterly, basis. Fifth, participating State associations would be given credit for the amounts contributed to their State Supplemental Insurance Fund in the event that Congress or the FHLBB ultimately decides to establish a system of risk-related insurance premiums.

A BILL

To amend the National Housing Act to protect the rights of State-chartered savings and loan associations to engage in activities and make investments authorized under State law and to provide additional protection for the Federal Savings and Loan Insurance Corporation.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

That this Act may be cited as the "State-Chartered Savings and Loan Association Supplemental Insurance Fund Act".

Sec. 2. Title IV of the National Housing Act (12 U.S.C. 1724 et seq.) is amended by adding at the end thereof the following new section:

"Qualifying State Supplemental Insurance Funds"

"Sec. 415(a). Any insured institution that is chartered under the laws of any State and that participates in a State Supplemental Insurance Fund that has been certified pursuant to subsection (b) (hereinafter "Participating State-Chartered Association") shall be entitled to the following relief from the regulations of the Corporation:

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"(1) Notwithstanding 12 C.F.R. § 563.9-8 of the Corporation's Regulation of Direct Investment by Insured Institutions, a Participating State-Chartered Association may invest up to forty percent of assets in aggregate direct investments, unless applicable State laws or regulations provide otherwise;

"(2) A Participating State-Chartered Association shall be exempt from 12 C.F.R. § 563.13-1 of the Corporation's Net-Worth Requirements of Insured Institutions;

"(3) A Participating State-Chartered Association shall be exempt from 12 C.F.R. § 563.13(g)(5)(iii) of the Corporation's Net-Worth Requirements of Insured Institutions;

"(4) Notwithstanding 12 C.F.R. § 563.13(b)(5) of the Corporation's Net-Worth Requirements of Insured Institutions, a Participating State-Chartered Association shall be permitted to calculate its minimum net-worth requirements on an annual basis; and

"(5) In the event that the Corporation imposes risk-based insurance premiums on insured institutions, a Participating State-Chartered Association shall be entitled to a credit on such risk-based premiums in an amount equal to the amount that the Participating State-Chartered Association has contributed to a qualifying State Supplemental Insurance Fund either through income foregone or funds expended.

"(b) The Presidents of the various Federal Home Loan Banks are charged with certifying State Supplemental Insurance Funds within their respective regions. A State Supplemental Insurance Fund must be certified under this section if the State regulatory authority

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charged with administering the State Supplemental Insurance Fund demonstrates:

"(1) That the resources of the State Supplemental Insurance Fund are actuarially sufficient to insure twenty-percent of the assets of Participating State-Chartered Associations, up to a maximum of fifty million dollars for each Participating State-Chartered Association;

"(2) That the State Regulatory Authority charged with administering the State Supplemental Insurance Fund has the legal authority to appoint a conservator to manage any Participating State-Chartered Association that is in imminent danger of insolvency or that otherwise violates applicable State laws or regulations; and

"(3) That the State Regulatory Authority charged with administering the State Supplemental Insurance Fund has established a reasonable system of monitoring on at least a quarterly basis the financial condition of Participating State-Chartered Associations and examining such Associations on at least an annual basis.

"(c) For purposes of this section, the term 'State' means each of the several States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American Samoa, the Northern Mariana Islands, the Trust Territory of the Pacific Islands, and any other territory or possession of the United States."

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AN ACT

relating to the establishment, funding, and uses of the Texas Savings and Loan Supplemental Fund and to the creation, membership, administration, powers and duties, and dissolution of the Texas Savings and Loan Supplemental Fund Corporation.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF TEXAS:

SECTION 1. SHORT TITLE. This Act may be cited as the Texas Savings and Loan Supplemental Fund Act.

SECTION 2. PURPOSE. The purpose of this Act is to establish a fund in Texas to aid and assist the Savings and Loan Commissioner of Texas in maintaining the solvency of the associations that contribute to the fund and to safeguard the public interest and promote the public confidence in state chartered savings and loan associations doing business in the State of Texas by making available to the Savings and Loan Commissioner of Texas the additional resource of this fund to be used for the protection and rehabilitation of member associations' assets as well as the maintenance of the solvency of member associations.

SECTION 3. CONSTRUCTION. This Act shall be liberally construed to effect its purposes.

SECTION 4. DEFINITIONS. In this Act:

(1) "Member association" means any savings and loan association chartered under the laws of the State of Texas and that is a member in good standing of the corporation.

(2) "Commissioner" means the Savings and Loan Commissioner

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of Texas.

(3) "Corporation" means the Texas Savings and Loan Supplemental Fund Corporation.

SECTION 5. CREATION OF THE CORPORATION. The Texas Savings and Loan Supplemental Fund Corporation is created as a nonprofit legal entity. Membership in the corporation shall be available to any savings and loan association chartered under the laws of Texas which is insured by the Federal Savings and Loan Insurance Corporation and which meets the membership standards approved by the commissioner and adopted by the board of directors as a part of the plan of operation. A savings and loan association is eligible for membership only so long as it remains insured by the Federal Savings and Loan Insurance Corporation. The corporation is under the supervision of the commissioner.

SECTION 6. BOARD OF DIRECTORS. (a) All corporate powers of the corporation shall be exercised by a board of directors, and the board shall manage the business and affairs of the corporation. The board of directors shall consist of the members of the Savings and Loan Section of The Finance Commission of Texas and six members elected by the member associations voting at an annual meeting.

(b) The regular term of office of an elected director shall be two years and until a successor has been elected and qualified. Of the original board of directors, three directors who are representatives of the member associations shall be elected for two-year terms, and three directors shall be elected for one-year terms.

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(c) At its first meeting after each director's election, the board of directors shall elect one of its members as chairman of the board. The board may appoint such other officers and employees as it deems advisable.

(d) The board of directors may remove any elected director and thereby create a vacancy on the board if the board of directors by a two-thirds majority vote at any meeting called for that expressly stated purpose declares the office of director to be vacant because such director has failed to maintain the standards specified for directors set out in the plan of operation or if the director otherwise fails to perform any of the duties required of him as director.

(e) The office of a director becomes vacant if the director dies, resigns, or is removed from office. A resignation shall be presented to the commissioner or to the chairman of the board. A vacancy occurring during a term of office shall be filled by election by a majority vote of the remaining directors.

(f) A director shall be disqualified to vote, act, or join in acting on any decision calculated to directly and specifically affect an association in which that director has a direct interest.

(g) In the election of directors and in voting on any other matter legally to come before a meeting of the member associations, each member association has one vote to be cast by a delegate authorized to act by that association. A majority of votes so cast shall elect directors or determine any question put to a vote of the directors.

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(h) A quorum of the board of directors shall consist of not less than a majority of all directors; provided that a lesser number may adjourn from time to time and that a majority of directors holding office constitutes a quorum for filling a vacancy on the board.

(i) Regular meetings of the board of directors shall be held as determined by the board. Special meetings of the board of directors may be called by the chairman of the board, any three directors, or by the commissioner. Notice of the time and place of each meeting of the directors shall be given to each director and the commissioner at the time and in the manner specified in the plan of operation.

(j) The plan of operation of the corporation may provide for the creation by the board of directors of an executive committee consisting of not less than three directors. If authorized by the plan of operations, an act or authorization of an act by the executive committee within the authority delegated to it shall be as effective for all purposes as the act or authorization of the board of directors.

(k) The director shall not receive any compensation for serving on the board of directors, but is entitled to reimbursement for actual expenses incurred in performing duties as a director.

SECTION 7. POWERS AND DUTIES OF THE CORPORATION. (a) The corporation may exercise the powers of a nonprofit corporation created under the laws of the state, including without limitation the power to:

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(1) enter into contracts of any nature;

(2) sue and be sued;

(3) subject to the provisions of this Act, purchase, hold, lease, receive, use, encumber, sell, exchange, transfer, lend, advance, convey, assign, give, grant, transmit, hypothecate, or dispose of any property or funds of any description, nature, or kind or of any interest, right, title, or privilege therein from or to any member association or any other corporation or person or other entity and to take collateral as security for any loan it makes, the capital stock of, as well as the assets of, any borrowing member association and to hold or dispose of any such collateral acquired as a result of default in the payment of such loans in any manner consistent with the purpose of this Act;

(4) declare and pay dividends or interest on securities issued under the authority of this Act;

(5) borrow funds; and

(6) perform other acts not inconsistent with this Act necessary to enable the corporation effectively to promote and carry out its purposes.

(b) The corporation shall:

(1) make or issue, with the approval of the commissioner, a guaranty or other form of written assurance to the appropriate person, association, corporation, or other entity which is reasonably necessary to facilitate the sale, conveyance, assignment, transfer, or other disposition of all or any part of the property or assets of a member association which is subject to

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a conservatorship order of the commissioner and otherwise assist in the merger, consolidation, conservation, rehabilitation, or supervision of such member association upon the request and under the instruction of the commissioner;

(2) advance funds, with or without interest, upon such terms and conditions as the board may establish to aid directly or to provide special services for member associations subject to a conservatorship order of the commissioner to continue to operate and to maintain solvency;

(3) purchase from any member association, which is subject to a conservatorship order of the commissioner, interests in its assets at a price mutually agreed upon by the conservator of such member and board of directors, notwithstanding that such value may exceed the market value of the assets so purchased. A purchase shall be upon such terms and conditions as the board of directors may determine; provided, however, that all such terms, conditions, agreements, and values must be approved in writing by the commissioner;

(4) receive, in consideration for assistance provided under this Act, stock or other equity interest in the assisted member association or such other compensation acceptable to the board from the assisted member or another corporate entity which is a party to the transaction in which the assistance is rendered.

(c) A merger, sale of control of, or sale of any of the assets of a member association subject to a conservatorship order of the commissioner in aid of which funds from the supplemental

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fund have been advanced may be accomplished in such form and by such procedure that the board and the commissioner deem appropriate.

SECTION 9. TEXAS SAVINGS AND LOAN SUPPLEMENTAL FUND. (a) The corporation, acting on direction of the board of directors pursuant to the plan of operation, may require member associations to purchase preferred stock, certificates of participation, or other types of securities issued by the corporation bearing interest or paying dividends at a specified rate or a variable rate determined by a specific method of computation. The corporation shall allocate each security issue ratably among the member associations on the basis of the relationship of each association's total assets as of December 31 of the year next preceding the date on which such securities are issued to the total assets of all member associations as of that date. The form, terms, and other matters relating to each issue of securities by the corporation shall be determined by the board except that the aggregate amount any member association shall be required to purchase of all types of securities shall never exceed an amount equal to two percent of the total assets of such member association as reflected on the annual statement of such association for the calendar year prior to the date of the required purchase filed with the commissioner as required by law or regulation.

(b) The commissioner may defer in whole or in part a requirement that a member association purchase securities of the corporation if the commissioner believes that the purchase would

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endanger the ability of the member association to maintain its solvency.

(c) Upon the failure of a member association to make a required purchase of securities of the corporation by the 10th banking day after the date fixed by the board of directors for such purchase, the board may cancel the membership of the defaulting association in the corporation.

(d) If a member association elects to surrender its membership or becomes ineligible for membership or has its membership cancelled, such association may present any securities of the corporation it holds for redemption. The corporation may defer redemption for no more than three years and shall continue to pay interest or dividends required under the terms of such securities until they are redeemed.

(e) Securities of the corporation held by member associations represent authorized investments of a savings and loan association under state law.

SECTION 9. INVESTMENT OF THE FUND. (a) Funds from the sale of securities of the corporation constitute the primary account of the corporation. These funds may be invested in certificates of deposit or other interest-bearing accounts in a savings and loan association or commercial bank domiciled in the state or in securities of not more than five years duration issued by the United States government, the state, or any municipality or governmental entity of the state if the securities are direct obligations of or are secured by the full faith and credit of the

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issuer.

(b) The corporation shall establish an administrative account in which it shall deposit interest and other earnings on the investment of the primary account. When the balance of the administrative account reaches $50 million or five percent of the then current balance of the primary fund, whichever is greater, the corporation shall cease issuing securities until the balance in the administrative account is reduced below $50 million or five percent of the then current balance of the primary fund. If the balance of the administrative account exceeds at any time 20 percent of the then current balance of the primary account, the corporation may begin a plan of redemption of securities issued by the corporation.

SECTION 10. AUTHORIZED EXPENDITURES. (a) The corporation may expend money from the administrative account for the usual and normal business operations of the corporation.

(b) When the commissioner has placed a member association in conservatorship, expenditures from the administrative or the primary account shall be made if the commissioner requests and directs that such be done for the purposes authorized by this Act. In no event may the aggregate expenditure from the fund in aid of such member association exceed the lesser of (i) 10 percent of the current balance of the primary account, or (ii) 20 percent of such association's assets. Subject to these limitations, the plan of operation shall establish a maximum dollar amount which may be utilized for the purposes of this Act. Such amount shall represent the minimum amount to be expended by the commissioner prior to any

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certification of insolvency of a member association.

SECTION 11. PLAN OF OPERATION. (a) Promptly after the effective date of this Act, the commissioner shall prepare and promulgate a temporary plan of operation for organization of the corporation until the initial board of directors is selected, which plan shall include standards for membership in the corporation. After the directors have been selected and have taken office, the board shall submit to the commissioner its plan of operation which the board finds to be necessary and suitable to assure the fair, reasonable, and equitable administration of the corporation. Such plan shall become effective on approval in writing by the commissioner. The corporation may amend the plan from time to time and submit the amendment to the commissioner, and such amendment shall become effective upon approval in writing by the commissioner. Until the corporation submits a plan of operation the temporary plan promulgated by the commissioner shall remain in force until modified by the commissioner or superseded by a plan of operation submitted by the corporation and approved by the commissioner. The plan of operation must contain explicit standards for admission to and the retention of membership in the corporation. Member associations shall comply with the plan of operation.

(b) The plan of operation must:

(1) establish procedures for handling the assets of the corporation;

(2) establish the amount and method of reimbursing members

of the board of directors under Subsection (k) of Section 6 of this Act;

(3) establish regular places and times for meetings of the board;

(4) establish procedures for keeping records of financial transactions of the corporation, its agents, and the board;

(5) establish any additional procedures for issuing securities of the corporation under Section 8 of this Act;

(6) contain additional provisions necessary or proper for the execution of the powers and duties of the corporation.

SECTION 12. REHABILITATION OF MEMBER ASSOCIATIONS UNDER CONSERVATORSHIP. The commissioner, if a member association has been placed under conservatorship as authorized by law, may request and the corporation shall pay from the administrative or the primary account to the extent permitted by the provisions of this Act the funds so requested to be used to rehabilitate such association and minimize the chance that such association will be liquidated.

SECTION 13. EXAMINATION OF THE CORPORATION AND ANNUAL REPORT. The board of directors shall submit to the commissioner, by April 1 of each year, audited financial statements of the preceding calendar year, prepared in accordance with generally accepted accounting principles consistently applied. These statements shall be certified by an independent certified public accountant. The commissioner may require additional supplemental information he believes is necessary.

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SECTION 14. NO PREFERENTIAL TREATMENT. No preferential treatment shall be given by the commissioner to any savings and loan association in the regulation of that association solely because the association is or is not a member of the corporation.

SECTION 15. EXEMPTION FROM SECURITIES LAWS. Securities issued by the corporation under this Act shall not be considered "securities" under The Securities Act, as amended (Article 581-1 et seq., Vernon's Texas Civil Statutes). A person authorized and acting on behalf of the corporation is exempt from the registration and licensing provisions of that Act, with respect to that person's participation in a sale or other transaction involving securities of the corporation.

SECTION 16. TAX EXEMPTION. The corporation shall be exempt from all fees and all taxes levied by this state or any of its subdivisions, except taxes levied on real property.

SECTION 17. IMMUNITY. A member association or its agent or employee, the corporation or its agent or employee, a member of the board of directors, or the commissioner or his representative is not liable for an action taken or not taken in the performance of the individual's or organization's powers and duties under this Act.

SECTION 18. ADVERTISING PERMITTED. A member association may advertise or use for promotional purposes the fact that its assets are protected under this Act only to the extent and in the manner permitted and authorized by the plan of operation required to be adopted by this Act.

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SECTION 19. DISSOLUTION. On approval of the commissioner, the unanimous approval of the board of directors, and with the approval of two-thirds of the member associations, the corporation may be dissolved. Procedures for dissolution shall be established by the commissioner and the board. In the event of a dissolution, funds in the primary account shall be utilized to redeem any securities issued by the corporation and held by member associations. If the primary account be insufficient for this purpose, the administrative account may be used. Upon a dissolution, no part of the earnings of the corporation may be distributed to any person or member association, but shall accrue to the State of Texas.

SECTION 20. CONDITIONS UNDER WHICH THE CORPORATION MAY EXERCISE POWERS. (a) The corporation may not exercise any of its powers and duties under Section 7 of this Act until the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation have officially recognized that the corporation will in the exercise of such powers reduce and minimize the liability of the Federal Savings and Loan Insurance Corporation and have taken such action as may be necessary to permit member associations to utilize without direct or indirect restraint all of the operational power and authority they might have under the laws of the State of Texas and the rules of the Texas Savings and Loan Department.

(b) If member associations are required to contribute to any similar fund (other than in the form of premiums payable for insurance of accounts to the Federal Savings and Loan Insurance

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Corporation) the corporation may be dissolved as provided in Section 19 of this Act.

SECTION 21. EMERGENCY. The importance of this legislation and the crowded condition of the calendars in both houses create an emergency and an imperative public necessity that the constitutional rule requiring bills to be read on three several days in each house be suspended, and this rule is hereby suspended.

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S.B. No. 497

President of the Senate

Speaker of the House

I hereby certify that S.B. No. 497 passed the Senate on April 30, 1985, by a viva-voce vote; and that the Senate concurred in House amendment on May 25, 1985, by a viva-voce vote.

Secretary of the Senate

I hereby certify that S.B. No. 497 passed the House, with amendment, on May 23, 1985, by a non-record vote.

Chief Clerk of the House

Approved:

Date

Governor

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EXHIBIT III

Texas Savings and Loan Guaranty Fund Act
Business Plan of Operations
(Discussion Draft)

I. Objectives of the Fund ("Corporation")

II. Admission

III. Securities purchases

IV. Monitoring requirements

V. Management of funds

a. Collection

b. Investment

c. Disbursements

d. Redemptions of securities

e. Interest/dividend payments on the Corporation securities

VI. Removal

VII. Accounting and record keeping by the Corporation and member associations

VIII. Reporting

IX. Staffing

X. Advertising

XI. Dissolution of the Corporation

XII. Board of Directors

XIII. Other matters

XIV. Definitions

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I. Objectives

- To establish a fund in order to aid the Texas Savings and Loan Commissioner in maintaining the solvency of state chartered associations that are members of the fund.

- To increase public confidence in Texas State chartered associations by the additional resources available to the Commissioner for use in protection and rehabilitation of member association's assets and maintenance of their solvency.

- To complement the FSLIC insurance fund against the perceived increased risk of certain activities upon which the Federal Home Loan Bank Board has applied regulations which preempt, override, change, limit or displace the authority of state chartered associations under Texas State statutes.

- Members of the fund would be exempted from Federal regulations which override Texas state statutes. For member institutions this fund and the related exemption would empower the State of Texas Commissioner to be their principal regulator rather than the Federal Home Loan Bank Board.

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II. Admission

Membership in the fund is available to any savings and loan association chartered under the laws of Texas provided that such association:

- Completes the required application in a manner satisfactory to the Commissioner/board of directors;
- Signs a statement of its intent to comply with this plan of operations;
- Has included with its application a certificate of insurance from the Federal Savings and Loan Insurance Corporation;
- Is in compliance with the following financial, operational and managerial admission standards, which are to be determined by the Commissioner with approval of the board of directors:
  (a) net worth requirement as established by the State Commissioner;
  (b) liquidity requirements;
  (c) quality of assets;
  (d) interest rate risk exposure levels;
  (e) amount, quality and trend of earnings;
  (f) such other managerial, operational, or supervisory items as of concern to the Commissioner and board of directors.
- Submitted a three-year business plan
- Has agreed to pay for, at its own expense, any examination, audit, appraisal, feasibility study or other required service that the Commissioner deems necessary in order for him to evaluate the prospective member's application.

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- By resolution of its board of directors has signed an agreement not to sue the Commissioner, the Corporation, or its board of directors if the prospective member's application for admission is rejected based on failure to meet the standards.
- Is approved for membership by the Commissioner/board of directors;
- Makes the required securities purchase as specified later in this plan.

Due Process

A prospective member whose application has been rejected by the Commissioner has the right to request a formal hearing on the rejected application before the entire board of directors. This request shall be in writing and be received by the Corporation within 90 days of the application rejection date.

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III. Securities Purchases

Initial Securities Purchases

Each association whose application to the fund is approved by the Commissioner/board of directors in the initial securities purchase offering shall purchase securities of the fund in an amount equal up to 2% of its total admitted assets. Admitted assets are to be determined from approved statements as of the last business day of December of the previous year. In no event shall the aggregate amount of all issues of all types of securities exceed an amount equal to 2% of the total admitted assets of all member associations.

The 2% of admitted assets initial securities purchase can be accomplished via a two-year phase-in payment scale as follows:

(a) securities of the Corporation amounting to 1% of a member association's admitted assets are to be purchased in the initial securities purchase;

(b) securities of the Corporation amounting to 1/2% of a member association's admitted assets as measured at the initial securities purchase date plus or minus 2% of the change in the association's admitted assets since the initial securities purchase date are to be purchased on the one-year anniversary date of the fund;

(c) securities of the Corporation amounting to an additional 1/2% of a member association's admitted assets as measured at the initial securities purchase date plus or minus 2% of the change in the association's admitted assets since the one-year anniversary date

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of the fund are to be purchased on the two-year anniversary date of the fund.

At all times during the two-year phase-in purchase arrangement each member association shall pledge 2% of its admitted assets to the Corporation in a manner acceptable to the Commissioner. Once the member association has purchased securities equal to 2% of its admitted assets, the pledge agreement will be retired.

The time period for the initial securities purchase offering shall be for a period after the formation of the Corporation as determined by the Commissioner, subject to the approval of the board of directors.

Associations who wish to be admitted as members after the initial securities purchase offering period has expired will be subject to the following purchase requirements:

(1) If application for admission is made during the initial two year phase-in period, the securities purchase requirement shall be that required during the phase-in period for the initial members. Additionally, non-refundable interest at prime + 2% (prime as quoted by Citicorp), will be charged from the period from the initial purchase date until the date of application. The index for calculating the interest charge may be changed from Citicorp prime to some other appropriate index with approval of the Commissioner and the board of directors.

(2) If application for admission is made subsequent to the three year phase-in period, the securities purchase requirement shall be equal to 2% of the association's admitted assets. Additionally, non-refundable interest at prime + 2% as described above, will be

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charged from the initial purchase date until the date of application.

(3) The interest charge for associations applying for membership after the initial purchase period can be waived or deferred at the discretion of the Commissioner, with board of director approval.

Supplemental Securities Purchases

Each member association shall annually purchase or redeem securities of the Corporation which amount to 2%, or the appropriate percentage during the phase-in period, of the growth (shrinkage) of the member's admitted assets since the prior years' measurement (securities purchase) date. The measurement (securities purchase) date is December 31 of each year. Admitted assets are to be determined from approved statements each December 31. The members have ten banking days subsequent to each December 31 to purchase securities or request redemptions of securities based on the most recent December 31 measurement (securities purchase) date.

The Commissioner may defer, in whole or in part, the call upon a member to purchase securities of the Corporation if, in his opinion, the purchase of such securities would endanger the ability of the member association to maintain its solvency. This deferment must be restored in the future at the Commissioner's request.

Any member who fails to purchase securities of the Corporation within ten banking days of the required date established by the Commissioner/board of directors shall be reported to the

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Commissioner, who shall take such action as authorized by law, including revocation of the right of the defaulting association to membership in the Corporation.

IV. Monitoring Requirements

The on-going monitoring of the member associations is the responsibility of the Commissioner. Upon discovery of an impaired or potentially impaired association situation, the Commissioner, with concurrence of the board of directors, may take action at his discretion to minimize the loss to be incurred by the Corporation. In this regard, the Commissioner has the authority to require audits, appraisals, engineering studies, feasibility studies, etc., which aid in the monitoring and solving an impaired situation.

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V. Management of Funds

A. Collection

The sale of the Corporations' securities shall be at the direction of the Commissioner/board of directors. Within ten banking days of the date fixed by the board of directors for purchase of securities, the member associations are required to transfer funds to pay for the securities in accordance with the securities purchase requirements as specified in Section III of this plan. These funds are to be deposited in the Corporation's primary account. Additional purchases of the Corporation's securities or any assessments made by the Commissioner are subject to the ten day payment period noted above commencing from the designated notice date.

Any member association who fails to meet the ten-day purchase period shall be reported to the Commissioner, who shall take such action as authorized by law. Members who are in default will be charged a late fee. This nonrefundable late fee will be interest on the required securities purchase amount at prime + 2% (as quoted by Citicorp) for the number of days payment is in arrears.

B. Investment

As the objective is investing the Corporation's proceeds in relatively risk-free investments, funds from the sale of securities which constitute the primary account and funds which constitute the administrative account, may be invested in

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certificates of deposit of any savings and loan association or commercial bank domiciled in Texas which is approved by the board of directors, or in securities of not more than 5 years duration issued by the United States government or its sponsored agencies, the State of Texas, or any municipality or governmental entity in the State of Texas representing direct obligations of the issuer or secured by the full faith and credit of any such governmental body.

While preferential consideration shall be given to investing funds of the primary account and the administrative account in depository institutions domiciled in the State of Texas, the investment of funds from the primary account is at the discretion of the Commissioner/board of directors. The Commissioner/board of directors may employ the use of investment bankers or other professionals to manage or advise in investment decisions of the Corporation.

A separate account to be known as the administrative account shall be established for retention of interest and other earnings on the investment of the primary account. The interest and earnings shall accrue in that account until it has reached the greater of $50,000,000 or 5% of the current balance of the primary account. When the balance of the administrative account exceeds the greater of $50,000,000 or 5% of the current balance of the primary account, no additional securities may be issued by the Corporation until and unless the balance of the administrative account is utilized in the aid of an impaired association and thereby reduced below the greater of $50,000,000 or 5% of the current balance of the primary account.

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C. Disbursements

From the administrative account, the Corporation is authorized to expend funds for the usual and normal business operations of the Corporation. Expenditures of this nature require approval by the Commissioner/board of directors.

The Commissioner, with the concurrence of the board of directors, has the duty and authority to make expenditures for facilitating the sale, transfer or disposition of assets of impaired member associations. Such expenditures shall be made first from the administrative account until that account decreases to a base level determined by the Commissioner at which time the Commissioner shall expend funds, if necessary, from the primary account. Total expenditures in aid of any single impaired member association shall not exceed the lesser of:

(1) 10% of the current balance of the primary account, or

(2) 20% of such member's admitted assets as of the previous December 31.

These expenditures are anticipated to be in the form of cash disbursements or other assistance from the Corporation. The Commissioner, if an impaired association condition exists, may utilize funds of the primary and administrative accounts up to the limits noted previously to rehabilitate such impaired member association and minimize the chance that such association will be liquidated.

The Corporation shall obtain preferential lien treatment when it grants assistance in impaired association workout situations.

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These expenditures are generally anticipated to be in the form of assistance given by the Corporation to a surviving association (one who takes over assets of the impaired association) and in return the Corporation would receive some type of subordinated debt or preferred stock of the surviving association. It is intended that when recovery is made on assets of an impaired association the Corporation would recover its investment plus any return that exists.

D. Redemption of securities

If the balance of the administrative account exceeds 20% of the primary account balance, the Corporation may redeem the securities in excess of that amount. This redemption, if approved by the Commissioner/board of directors, will be made on an annual basis and shall be uniform among members of the Corporation.

E. Interest/dividend payments on the Corporation securities

The Corporation shall pay interest or dividend on the securities on a quarterly basis to the members in good standing. The rate of return on the securities that the Corporation pays is to be established by the Commissioner with board of director approval.

Interest and dividends will accrue to the members during the first six months of their membership in the Corporation, however, interest and dividends will not be disbursed until the administrative account has reached the amount required in section V. D. of this plan.

The Corporation may make no assessments to the members.

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VI. Removal

Voluntary

In the event a member association elects to no longer retain membership in the Corporation, such association may present any securities of the Corporation for redemption. At its option, the Corporation may defer redemption for no more than three years from the withdrawal request date. In the event a redemption is deferred, interest or dividends shall continue to be paid on the securities until they are redeemed.

In the event a member wishes to withdraw from the Corporation when the primary account has decreased below 2% of the members' admitted assets, the redemption to the withdrawing member would be a percentage of his investment as calculated below:

$$\frac{\text{\% of total admitted assets at member withdrawal date}}{\text{2\% of total admitted assets at member withdrawal date}} \times \text{Member's Investment} = \text{Redemption due member to be returned in at least 3 years}$$

Any recoveries in the primary account subsequent to the member's withdrawal will revert to the Corporation rather than to the withdrawing member association.

Involuntary

When a member instution has been declared to be in an impaired situation by the Commissioner and the Corporation has paid the maximum allowable per association, (see section V. E.) (the

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lesser of 20% of the member's admitted assets or 10% of the balance in the Corporation's primary account) the Commissioner, subject to board of director approval, has the authority to remove the member from the fund. This involuntary removal entitles the association to none of the proceeds of its investment in the Corporation's securities or any accrued interest thereon.

Due Process

The association which has been involuntarily removed has the right to appeal the Commissioner's removal decision to the entire board of directors.

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VII. Accounting and record keeping by the Corporation and Member Associations

Corporation

The books and records of the Corporation will be maintained in accordance with generally accepted accounting principles (GAAP).

Member Institutions

The member associations shall record as an asset its investment in the securities of the Corporation at cost. This treatment is in accordance with generally accepted accounting principles and it is based on the fact that no linkage exists between the investment by the association and the deployment of the funds by the Corporation.

For example, assume an association pays $1,000,000 for its guaranty fund securities which bear interest at 10%. As consideration will be given by the Corporation to invest the funds in depository accounts of member associations, the Corporation invests the $1,000,000 in deposits of the association at an interest rate of 12%. In this case, because only the Corporation has the authority to invest the funds and can invest them in other associations and in other assets, netting the asset and liability on the associations' records is not proper. The asset and liability should be recorded at cost and the effective cost of the fund investment will (2% negative spread) impact the income statement each period.

The investment in the Corporation securities should be adjusted when it is probable that the asset had been impaired and the amount of the loss can be reasonably estimated per the Financial Accounting Standards Board Statement Number 5.

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Permitted Asset

It is the intent of the fund that the member's investment in the securities of the Corporation to qualify as permitted assets under the regulations of the State Commissioner of Texas.

VIII. Reporting

The board of directors shall submit to the Commissioner by April 1 of each year audited financial statements of the preceding calendar year prepared in accordance with generally accepted accounting principles consistently applied. These statements shall be certified by an independent certified public accountant. The Commissioner may require additional supplementary information he believes is necessary.

Additionally, the Corporation shall issue quarterly unaudited financial statements to the member associations.

IX. Staffing

The size and mix of the Corporation staff is to be determined by the Commissioner with board of director approval. The Commissioner shall determine the administrative, clerical and professional needs of the Corporation and shall use the Corporation's funds to staff it with the most qualified professionals available.

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X. Advertising

The Commissioner, with the approval of the board of directors, has the authority to establish public disclosure requirements. It is anticipated member associations will be able to disclose to customers that the association is a member, "Texas Guaranty Fund."

XI. Dissolution of the Corporation

As stated earlier in this plan, one of the purposes of the plan is to receive exemption from federal regulations which override Texas state statutes. As the federal exemption is imperative to the life of the Corporation, if Federal exemption is denied or removed, the Commissioner with the approval of the board of directors will commence the orderly redemption of securities liquidation of the Corporation.

Exclusive of the above dissolution provision, with the approval of the Commissioner and by the approval of the board of directors and by the approval of two-thirds of the member associations, the Corporation may be dissolved. Procedures for dissolution shall be established by the Commissioner and board of directors.

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XII. Board of Directors

All corporate powers of the Corporation shall be exercised by and under the authority of, and the business and affairs of the Corporation shall be managed under the direction of its board of directors. The board of directors shall consist of nine (9) members: the three members of the Savings and Loan Section of the Finance Commission of Texas and six members who shall be elected by the member associations voting at an annual meeting.

The regular term of office of an elected director shall be three years and until a successor has been elected and qualified. Of the original board of directors, two directors who are representatives of the member associations shall be elected for a two year term, and two directors shall be elected for a one year term.

The board of directors shall elect one of its members as chairman of the board and may appoint such other officers and employees as it deems advisable.

The board of directors may remove any elected director and thereby create a vacancy on the board if the board of directors by a two-thirds majority vote at any meeting called for that expressly stated purpose declares the office of a director to be vacant becausee such director has failed to maintain the standards specified for directors set out in regulation or plan of operation or if the director otherwise fails to perform any of the duties required of him as director.

The office of a director becomes vacant if the director dies, resigns, or is removed from office. Any resignation takes effect immediately or at such time following the date of delivery of his written or oral resignation as the director specifies. Resignations shall be presented

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to the Commissioner or to the Chairman of the Board. Vacancies occurring during a term of office shall be filled by election by a majority vote of the remaining directors.

A director shall be disqualified to vote, act, or join in acting on any decision calculated to directly and specifically affect an association in which that director has a direct interest.

In the election of directors and in voting on any other matter legally to come before a meeting of the member associations, each member association has one vote, to be cast by a delegate authorized to act by that association. A majority of votes so cast shall elect directors or determine any question put to a vote.

A quorum of the board of directors shall consist of not less than a majority of all directors, provided that a lesser number may adjourn from time to time and that a majority of directors holding office constitutes a quorum for filling a vacancy on the board.

Meetings of the board of directors may be called by the Chairman of the Board, any three directors, or the Commissioner. Notice of the time and place of each meeting of the directors shall be the responsiblity of the Commissioner. The board of directors should meet no less frequently than monthly.

The board of directors may create an executive committee consisting of not less than three directors. An act or authorization of an act by the Executive Committee within the authority delegated to it shall be as effective for all purposes as the act or authorization of the board of directors.

A director shall not receive any compensation for serving on the

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board of directors, but is entitled to reimbursement for his actual expenses incurred in performing duties as a director.

XIII. Other Matters

Budgeting

The Corporation shall furnish operating budgets to the Commissioner and board of directors on an annual basis with the board of directors being informed quarterly of the actual results of operations versus budget.

No Preference Relating to Membership

The Commissioner, in performing his duties as required by the State of Texas, shall not grant any preference to member associations or exert any pressure on non-member associations to become members of the Corporation.

Exemption From Similar Guaranty or Insurance Requirements

It is intended that membership in the Corporation will enable member associations to receive credit for this membership or exemption from the Federal Home Loan Bank Board, the Federal Savings & Loan Insurance Corp., or other applicable agencies which might assess additional insurance charges or reserve requirements or establish similar plans.

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The CHAIRMAN. Thank you, Commissioner.

CLASSIC PROBLEM WITH DUAL BANKING SYSTEM

Representative Evans, I suppose we have a classic problem here in trying to deal with the dual banking system and States rights. For all the years I have been on this committee I have been very concerned about States rights and preemption by Federal law. Over and over again when we have found it necessary to preempt, I have always insisted that we have an override of 2, 3, 4 years for State legislatures to have the right to say, "We disagree with you. We don't want to be overridden."

The problem we have in the dual banking system and trying to preserve it—and no one feels more strongly than I—is that we want that kind of flexibility and diversity in our banking system. But we have a problem particularly in the thrifts, where States have gone far, far beyond any deregulation activities that we in Congress have allowed. This is particularly true in the savings and loan industry.

So if we recognize that States have the right to authorize new activities, but then the risks of those new activities are borne by the Federal deposit insurance agencies, how do we resolve that conflict? I can sit here and repeat over and over again how much I believe in States rights and the ability of State legislatures to do that. But then if I've got a responsibility for the safety and soundness of institutions and maybe even more importantly, the continued viability of the FDIC and the FSLIC, and States are authorizing practices that we have not authorized but at the same time we're insuring them, how do we resolve that conflict?

Mr. EVANS. I am not prepared to give you an assessment of the Conference of State Legislatures position on that, but it would seem to me from my personal experience that, first, we must determine what activities—and that should be done by Congress—what activities are acceptable and allow the thrift institutions in the States who are under State regulation to participate. If they go beyond that, then I think that through risk-based premiums, a system that you are considering which I think is going to come about, that we would allow departure from that. But I think that Congress has the responsibility of setting certain minimum standards, but I do think—I agree with you wholeheartedly that the dual banking system is extremely important and it's something that the NCSL strongly believes in, of course.

The CHAIRMAN. Mr. Bailey, you've testified before this committee many, many times and always have been an advocate of States rights and State supervision. How would you respond to the same question?

Mr. BAILEY. It seems to me that if the remedy that is apparently being sought by the Federal agencies is to set the rules for everybody, we may reach a situation in which the protection of the insurer becomes more important than the protection of the depositors.

Now if the FSLIC or the FDIC can say banks may do this and savings and loans associations may do that, they have a very clear remedy and that is, "We won't insure you if you don't meet some

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standards suitable to this agency. It's up to you." And to say that everybody has to comply with these rules, whether or not you are endangering anybody by engaging in this activity seems to me a clear case of overkill.

To take off the leg up to the hip simply because one's toe is defective is not a remedy for the problem. It is overkill and I see this effort in that light.

The CHAIRMAN. Well, I'm not advocating taking anybody's leg off up to the hip or the knee. What I'm asking, to get back to the question, how do we resolve it? If you've got institutions out there, and we have, that are going far beyond what is allowed by Federal law but they are federally insured, now in that case shouldn't we sit back and say, "OK, we normally believe in States rights, but they are in practices that are endangering the safety and soundness," and why shouldn't we then say, "Well, we're going to put additional regulations or say if you don't meet this that you don't get insurance?"

Mr. BAILEY. Well, I think there are two different concepts involved. One concept is you may not by Federal law do this, that or the other, and that's the law. The other concept is, you may if you choose, but if you do, then you won't be insured. I see a vast difference there and I don't know that I would object to saying that if you don't meet whatever standards the FSLIC or the FDIC sets for insurability we just won't insure your deposits.

If State law permits you to remain open uninsured, fine, go right ahead. But then that puts the burden where it belongs, on the State, to either permit that institution to stay open or not. It doesn't become a burden of the Federal Government to control what the institution does. It doesn't become the Federal Government's responsibility.

The CHAIRMAN. Mr. Bowman.

Mr. BOWMAN. Mr. Chairman, the question, as I understand it, relates to some of the endeavors that Chairman Gray has mentioned as being extremely entrepreneurial that have surfaced in the S&L industry in the last few years and I agree with Commissioner Bailey's position. I think the problem lies in dealing with people whose motives are considerably less than legal and whose approach to the S&L business has gone beyond entrepreneurship and into, as we mentioned before, into greed and fraud. We do have some States that have, in my opinion, exceeded their prudent limits in terms of allocation of endeavors of a savings and loan into such things as their service corporation activity. For example, the Noland bill in California which allows 100 percent of an association's assets to be placed in ventures. And I think that's a problem that can be addressed more directly by Commissioner Crawford and his staff in California.

IMPEDIMENT TO POLICE S&L'S

But I do think that the one thing that has impeded the FSLIC and the Federal Home Loan Bank, as well as to some extent the State commissioners also, is the fact that we refer to these funds as insurance funds when in fact they are not, because if they were insurance funds and a person hit a neighbor's car, about the fourth

or fifth time he did that you would cancel his policy. The policy cancellation process by which the FSLIC is bound is, at best, a 2-year with agreement, and 6-year without agreement process, which allows for, in my opinion, no real threat. If an association's improper activities, without denying them any due process of law, could be addressed directly by both the State and Federal authorities by simply saying, "We will deny your insurance of accounts and give your depositors 6 months to remove their funds," then I think there would be a significant impact on the way the industry is conducting itself today.

The bill that I referred to in my earlier testimony in Texas, of course, does not relate to withdrawal of insurance because that's not my responsibility, but the act of involuntary conservatorship is frankly one that I intend to use with great success when the bill becomes law on August 27. I have been quoted as saying I will close 12 associations in Texas. That's incorrect. I don't have any particular list of associations to close, but I certainly have some associations whose management will be notified at that point in time that their activities will be curtailed and perhaps to the extent of actually placing a supervisor or conservator in the association.

I think these things done on the State level where problems can be more easily identified and dealt with is certainly the means of handling what we see as the new approach to, as I said, the entrepreneurship in the S&L business.

Going beyond that, as you mentioned earlier, if you could have, as we do, a business plan filed with the request for insurance of accounts of any new institution, and that business plan must at least within the limits of a varying economy be followed, and if it is not followed then it would be grounds for going back into that association at a later time and removing its insurance of accounts.

These tools have to be used, have to be made available to the regulator. Chairman Gray stated last year—and I'm an unlikely advocate of his but nevertheless, he did make a statement that we have deregulated the industry but we have not deregulated the regulators, and I think that's absolutely true.

The CHAIRMAN. Well, I don't disagree with you on the fraudulent activities of some, but let's just go back and assume that there is no fraud, there is no dishonesty, there is no mismanagement, but we're in a situation where a State has allowed much broader powers that some would consider risky or even entrepreneurial. And we are forced to go in and entirely clean out an operation because the State allowed them to go much further than we would. However, it's Federal insurance again. How do we resolve that conflict? Do we then come in and say, "OK, we don't like what you're doing so you can't have Federal insurance?" Because just the opposite trend is taking place. Representative Evans, I believe, said, "I certainly have no intention of proposing nor would I support any statute here that would require all State institutions to have Federal insurance," but they're going to. After Ohio and Maryland, the marketplace is going to take care of that and you're not going to have too many institutions left unless they do have Federal insurance. So that compounds the problems of this committee.

OK. We have State legislatures and courts making decisions that go far beyond what this committee has or intends to make in terms

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of new powers, but with Federal insurance and funds that by some standards are inadequate to handle the problem. So do we just withdraw and say, "You can't have it any more unless you comply with our standards?" And then do we get State regulators saying, "Now you're infringing on States rights."

You've got a philosophical conflict there but a real problem in terms of protecting Federal insurance as well as depositors. So how do we handle it in a clean operation?

Mr. BOWMAN. Senator, I would suggest that you address, rather than a question of a laundry list of acceptable or unacceptable practices, the question of the quality of State supervision and let's determine standards working together to certify, if you will, in line with the recommendations of the Bush task force—certify States as having qualified sufficient supervision. And in those States that have this benefit, that we then address the problem of asset deregulation as it would apply to that State. Certainly not to all States.

Mr. EVANS. Mr. Chairman, if I may inject one further comment in response to yours, I would characterize the position of the NCSL as being one of not being so much opposed to the requirement of Federal insurance, but that Congress not foreclose the additional option of either State-backed funds or private funds for purposes of possibly going beyond, as we've discussed, what the requirements would be set by Congress.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

I have listened to your testimony which has been lengthy, but I'm not clear in my mind as to what reforms, if any, any of the three of you feel need to be made with deposit insurance. I notice, Mr. Bailey, that you say it's difficult to develop a risk-related premium system.

I'd like to know what the three of you support in the way of changes in the deposit insurance system, just as blunt and as much in a bottom line form as you can give it to me.

Mr. Bailey, why don't I start with you, and then Mr. Bowman and Mr. Evans.

REDUCE COVERAGE TO $40,000

Mr. BAILEY. Well, I believe I did suggest, Senator, in my comments that the whole purpose of deposit insurance I think has been diverted. There is a concept now that deposit insurance insures the institution and that's even been converted to a notion that some purpose here is to insure the fund. I think if it were redirected to insuring the depositor—and one way to do that is to reduce the amount of coverage perhaps back to as little as $40,000, and then the depositor's interest would be paramount to the insurer, the impact of the failure of the institution on the fund would be reduced and some of the present sources of risk to the institution I believe firmly would be removed.

Senator RIEGLE. So you would propose that the insurance limit be reduced from the $100,000 per depositor down to something like $40,000. Is there any other change you would recommend?

Mr. BAILEY. I think that would do it, sir.

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Senator RIEGLE. Mr. Bowman, how about you?

Mr. BOWMAN. Senator Riegle, in two parts of the testimony that I submitted I may not have made myself clear. One of the suggestions that I would make is to endorse what Mr. Janis said last week, and that is to decentralize the FSLIC.

Also, I am in favor of separating it from the Bank Board because the insurer and the regulator should function independently of each other and not one subject to the other's whim.

In addition to that, I feel that this use of Federal Home Loan Bank System's excess net worth to shore up FSLIC is one whose time has come and it is a source of the funds so sorely needed by the insurance corporation and I think that should be examined also.

Senator RIEGLE. How do you react to Mr. Bailey's idea of dropping the insurance limit to some lower figure like $40,000?

Mr. BOWMAN. I hate to disagree with my cohort, Mr. Bailey, but I'm afraid all that will do is move money around one more time. When I began in the savings and loan business, the insured limit was $5,000 and the same depositor is there today. He now has $100,000. And if you back him to $40,000 he will merely go down the street and shift money around one more time and it makes it a little more difficult for him, and my mother, for example, who is 83, to manage her assets. I feel that that particular solution would have some merit but I'm afraid it would have some drawbacks in terms of public service.

Senator RIEGLE. Mr. Evans.

Mr. EVANS. Senator, I believe that it is an accurate statement to say that the Conference of State Legislatures believes that developing a system of risk-related insurance is probably the one item that certainly should be pursued. I believe that that would be good for the industry, the consuming public, and I believe that it would answer some of the questions that have been raised here this morning, and I believe that our association is on record as supporting your pursuance of that system.

I think that requiring higher minimum reserves, although I believe that is probably a policy set by the Federal insurer, I know our experience in North Carolina, where we have had probably the best private insurance fund, has been to require a higher reserve than is the Federal average I think of 3 percent whereas the State requires 5 percent for their institutions.

Several other items that I mentioned as meriting additional inquiry by this committee would be the possibility of additional supplemental premium assessments, borrowing from the FDIC to—I think the main problem as we see it and probably as you have already heard is with the savings and loan industry and the FSLIC. I don't know that that is a long-term solution, but that's certainly a possibility.

Another area that we have suggested is consideration of increasing the flat-rate premium, but as I have pointed out, we believe that to base it more on risk involved is a fairer system and one that would serve the industry and the consuming public much better.

ADEQUACY OF SUPERVISION FUNCTIONS

Senator RIEGLE. Let me ask the three of you what steps you would recommend or feel are needed to strengthen the examination and supervision function of institutions?

Mr. Bailey, what is needed there at this time, if anything, in your view, in the area of examination and supervision?

Mr. BAILEY. Specifically, examination and supervision of banks, Senator, I am bound to conclude that it is effective as it is. Bank failures now in the recent past at least can be attributed largely to factors beyond the regulators control. No matter how effective regulation and supervision may be, if the economy of the bank's market suffers reversals, the bank follows that because it depends upon that community and that market for its own income. And I don't know how you can devise a system of bank regulation to prevent what's happened to the agricultural economy, for example, in the Middle West right now.

Senator RIEGLE. Well, I can appreciate your point. You're talking about systemic problems in agriculture or some other foreign loans in institutions, but we have had an awful lot of cases that don't fall into those categories where we've had improper activity going on. The question is: Couldn't this be determined sooner so that we don't wait until a lot of other institutions, who perhaps are in the chain of loans that are being farmed out—like we saw in Penn Square and other situations go under as well. Is there nothing more that can be done in the supervision area to try to dig these cases out, or do we just have to wait until they blow up in our faces?

Mr. BAILEY. Well, I hesitate to say that nothing more can be done. I recall a former Comptroller of the Currency having said one time that he could tighten the screws down on supervision and regulation to the point where there would be no failures. In that case, of course, a bank would make no loans. It would cash checks and that would be about its only permissible function. I don't see that as being in the public interest. There has to be an element of risk.

Now the extent to which that risk is allowed to continue over a long period of time, perhaps that's the real point here. I really am of the opinion that it is now allowed to continue over a long period of time.

Senator RIEGLE. You feel pretty good about the system now and you don't really have any significant changes to recommend in the area of supervision or examination?

Mr. BAILEY. And bank regulation, yes, sir, I guess I do.

Senator RIEGLE. How about you, Mr. Bowman?

Mr. BOWMAN. Senator Riegle, the bill that I referred to earlier that was passed by the Texas Legislature this year was a cooperative effort between the industry and my department and, frankly, its purpose was to do exactly what you're talking about; and that is to give the Texas Savings and Loan Department the tools that it needed to act in a much more rapid fashion than we have in the past.

In terms of examination, I think identifying the problem—and I'll agree with Commissioner Bailey on this—I think the problems

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are easy enough to identify. If you're dealing with theft, we can't get there ahead of the thief, no. But in terms of improper practices that can be identified early and then addressed by supervision, yes, I think that mechanism is in place. And I will invite you again to exhibit 1 of my testimony which is the monitoring system which we intend to put into effect in Texas. As a matter of fact, it is in effect now on a limited basis and we feel that anything that can be gleaned from numbers on an association can be identified early, within 30 days of its happening, through this system.

The Bank Board chose 2 years ago to go to a 90-day or quarterly report if you will, and we never did away with the old monthly report because we feel that the timeliness of this thing, particularly with the industry under its present attack, needs to be maintained.

Senator RIEGLE. Mr. Evans, my time is up but I'd like you to have a chance to respond.

Mr. EVANS. Very briefly, I do not believe that the supervision is adequate at the present time. I think that the situation that has been demonstrated in North Carolina through the private fund that I mentioned earlier, who I believe you're going to hear from later this morning, has indicated that the key to their success has been in fact the very close supervision, a month-to-month monitoring of the the loans and the activities of the S&L's that they insure. In my opinion, that is a major key to preventing failures and I think that we certainly ought to look at closer supervision.

Senator RIEGLE. Thank you.

The CHAIRMAN. Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

I have one question of this panel. One of the primary recommendations made by both the FDIC and the Federal Home Loan Bank Board is a move toward so-called risk-based insurance premiums, basing the premiums on how risky the bank or S&L business is.

I'll ask you, Mr. Bailey, what is your reaction to this business of basing insurance premiums on risk?

DEFINING RISK

Mr. BAILEY. Well, the concept has, at least initially, validity. The practical problems that arise is defining what is risky. Who is to make that definition? Is there to be some defined list of activities that somebody says is risky in every case and everybody who does this thing or these things will pay a higher premium?

That would be extraordinarily difficult, to say that a given activity has a given level of risk in every case. It seems to me it would be nearly impossible.

Senator SASSER. Well, the FDIC says that it does not want public disclosure of the ratings that banks receive from the bank regulatory agencies as the Chairman said in his testimony last Tuesday, and I quote him, "They are sometimes wrong"—talking about I suppose his regulators—"on either the low or high side. Yet, they would be accorded overwhelming weight by the public," talking about the FDIC's ratings.

So if the regulators opinions are so fallible on their bank ratings, do you think, Mr. Bowman, they would be able to assess risk any

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better for the purpose of calculating premiums on their risk-based insurance?

Mr. BOWMAN. Senator Sasser, I'll have to agree again with Mr. Bailey. I think the idea of risk-based premiums is rhetorically brilliant and practically impossible. The problem exists in who's going to make the list and the restructuring committee of the U.S. Savings & Loan League took the position about a month ago that the idea of risk-based premiums was a good idea that was almost impossible to implement. However, if you will turn that around and use the capital levels that must be maintained by an institution, that level to be based on a risk, then I think you have a different animal because, while you give a premium away to FSLIC not to be returned to you; hopefully, under the capital requirement you simply recapitalize or increase the capital in your association based on this perceived risk.

So if the regulator is wrong in his perception of risk, all you have done is made your institution stronger as a result of it.

Senator SASSER. Well, would you make it unanimous, Mr. Evans, that this panel looks with a jaundiced eye on the question of risk-based insurance?

Mr. EVANS. Senator, I'm not sure I would. The position of the National Conference of State Legislatures, which I'm representing today, thinks that it is necessary and desirable that this committee and the Congress look at a system of risk-based premiums. I am not an expert in the field. I am a citizen-legislator and practice law to make a living, not serving in the General Assembly of North Carolina, but my personal opinion is that any kind of management or regulation that we're talking about at some point has to involve subjectivity, and I don't believe that you can create a system, as has been pointed out, that is not going to be subjective.

But we've got to start somewhere and I think that to base our insurance on the kind of risk involved, however it may be defined, is certainly better than keeping it flat-based, and I think it is incumbent on this committee that you look at that.

Senator SASSER. Gentlemen, thank you.

The CHAIRMAN. Senator Dodd.

Senator DODD. Mr. Chairman, my questions have been asked so I'll defer. I thank the panel for coming.

The CHAIRMAN. Gentlemen, I have no more oral questions for you. I would just comment on one of Mr. Bailey's answers to the risk-related premiums. I don't know the answer to that. I don't know how to design a system at this point. But I would hope you would reserve judgment.

We've heard two or three times now that it's a good idea but it's impossible. I don't like the word impossible. I can't imagine the number of times I've been told that something was impossible that I was able to later work out; so all I request is you give us a chance to look at it. Maybe we'll come back and say, "Those gentlemen were right. It's impossible." But let's not prejudge it until we have an opportunity to examine it.

I happen to think that it is possible to design a system but a lot of people are going to say, "Hey, I don't like that. I don't like to be classified." But we've got a problem out there. That's what these hearings are all about. We've got a problem. We've got a system to

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preserve and so maybe risk-related premiums aren't the answer or even a partial answer, but it's one the committee is going to take a serious look at.

So at least reserve judgment for a while until we get through the series of hearings and evaluation of various systems. I don't think any one idea is going to solve the problem. I think it's going to take a combination of factors to put our insurance systems in a more secure position and rebuild confidence out there in the marketplace.

Thank you very much for your willingness to testify.

[Response to written questions from Charles D. Evans, Sidney A. Bailey, and L.L. Bowman follow:]

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National Conference of State Legislatures

Office of State Federal Relations

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN

FROM

CHARLES D. EVANS, NORTH CAROLINA HOUSE OF REPRESENTATIVES

Q. 1. How does Congress preserve the dual banking system if we recognize that states can authorize new activities but the risks of those activities are born by the federal deposit agencies? Is non-federal insurance an answer?

A. (1) We must not overlook the fact that the activities of state-chartered institutions extending beyond those authorized for federally-chartered institutions are frequently sound, minimal risk powers. They produce consumer benefits, as increased competition, help maintain institutional soundness, and serve as a testing ground for activities which ultimately might be permitted federally-chartered institutions. Therefore, federal insurors benefit, at a minimum, through continuous payment of preminum obligations from institutions whose capital health results, in part, from the flexibility inherent in the dual banking system.

We must also remain cognizant of those financial institutions which falter and/or fail due to managerial ineptness and irresponsibility despite the fact that these institutions engage primarily (and sometimes solely) in "traditional" banking activities. The federal deposit insurance system frequently rescues these institutions with reserves provided, in part, by banks and/or thrifts engaged in "new" activities.

NCSL supports a risk-based premium concept because it should allow for the assignment of degrees of risk to new activities. This assignment ought to eventually be included in a premium assessment. Bank lending policies, consumer credit assessments and FDIC's CAMEL system are just three examples of how soundness (or risk) is already measured within the industry and among regulatory agencies. Real estate activities or loans for off-shore drilling can be assessed for risk just as easily as consumer or commercial lending. NCSL urges, however, that the activity alone cannot be a sole determinant in a risk-based premium assessment system. The organization would not, however, be opposed to an initial assumption that activities beyond those granted federally-chartered banks and thrifts might automatically give initial cause for a higher premium until there is sufficient evidence to indicate satisfactory or unsatisfactory impact on an institution's soundness.

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The second part of your first question asks whether non-federal insurance is an answer. It is a limited one at best. I urge that the option be maintained. I am intrigued with the possibility that non-federal insurance might provide a reinsurance option or guarantee deposits over $100,000. North Carolina's FIAC has performed solidly because it has been well-financed and monitored, two essential ingredients which are critical for fund performance and ultimate consumer confidence. However, recent thrift crises outside North Carolina have virtually guaranteed that its days are numbered.

Q. 2. To the extent that non-federal deposit insurance is part of the answer, should federal agencies take the operation and funding of such insurance into account in assessing risk-based insurance premiums?

A. (2) To the extent that non-federal insurance serves as a major insurance vehicle, say for certain credit unions or thrifts, or as a reinsurance device, its operation must be measured within a risk-based premium system. I expect nothing less from FDIC and FSLIC. Its funding adequacy should also be taken into account although I do not believe that a state should be compelled to put its treasury behind any non-federal insurance fund. To do so would eliminate much of the discipline required to contain the operations and procedures of institutions suspected of being irresponsible and unsafe. That is a part of the hypocrisy of the U.S. Treasury standing behind FDIC and FSLIC. All that really stands behind these funds is a larger federal debt burden ultimately paid off by taxpayers, the overwhelming majority of whom bank at sound financial institutions.

Q. 3. Will you keep this Committee informed as to NCSL's Committee review of risk-based capital and other related issues?

A. (3) I am hopeful that NCSL's Government Operations and Regulation Committee can complete its review of risk-based capital and related issues by mid-December, 1985. The organization's findings and any policy modifications will immediately be forwarded to the Senate for your perusal.

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Q. 4. Is there a place for self-regulation in the banking industry that draws on the talent within the industry? If so, how could concepts of self-regulation be included in the federal supervisory system?

A. (4) For someone who is essentially convinced that the preponderance of bank soundness problems stem from questionable management, the concept of self-regulation seems most inappropriate. Possibly, when the nation has had more experience with deregulation and its affects, the concept should be pursued. I see some potential benefit in that it would free up limited supervisory resources to concentrate on faltering and troublesome institutions. My sense, at this time, is that utilizing self-regulation as a federal supervisory (or state supervisory) tool would be premature. Your question does indicate that supervisory resources have been allowed to grow unnecessarily thin, a problem Congress needs to rectify.

Q. 5. With regard to the concern that some states may have expanded banks product authorities beyond what may be prudent, can this issue be dealt with by giving the federal insurance agencies the authority to require a prudent level of capital to support that activity in order to maintain insurance - rather than giving any federal agency the authority to override a state legislature? In other words, wouldn't the adoption of risk-based capital standards go a long way toward solving this problem?

A. (5) Your question addresses one of the matters which NCSL is currently reviewing and, therefore, I request that the organization formally respond when our analysis is complete. One concept which Washington State has looked at is linking capital adequacy to branching privileges. I mention it since it is an idea which your committee might wish to review.

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Questions for Mr. Evans from Senator Proxmire

State Co-Insurance

If the States want to have the primary say-so as to when a state chartered bank is to be closed, why shouldn't they share part of the financial exposure with the FDIC?

For example, suppose we allowed the states to make these determinations on bank closing, to set risk based insurance premiums, and to set minimum capital standards, but only if the State agreed to share a fixed percentage of any FDIC losses resulting from the failure of a State chartered bank?

In other words,if a State wants to share in the decisions, it must also accept financial responsibility for those decisions and agree to share in the cost. Why isn't that fair?

Response to Questions from Senator Proxmire

State legislatures, in my opinion, have no inclination to become providers of deposit insurance for state chartered banks. While some states have tested and implemented private insurance (primarily for select thrifts and credit unions), I see no general disenchantment with the concept of and general supervisory/regulatory consequences emanating from federal deposit insurance.

States already share a portion of the financial exposure with the FDIC in that state-chartered institutions are assessed the same flat rate premium charge as federally-chartered institutions. State chartered banks are jeopardized whenever FDIC reserves dwindle, regardless of whether state - or federally-chartered banks have failed or required an emergency takeover. The question could be asked if whether a state-chartered bank should have to indirectly pay, through its premium the assessment, costs of a failed federally-chartered institution. My answer would essentially be yes because we are talking about an insurance system in which banks, not states, participate.

NCSL has not advocated any policy which would suggest, an does not suggest here that states would desire to set risk based premiums and set minimum capital standards for "joint" state federal insurance or a "co-insurance" system. We agree that powers granted state banks,when measured to be clearly more risky for an institution than traditional powers, ought to trigger an additional premium assessment. Please keep in mind that states do not expect any preferential treatment when their chartered-institutions, some with "new" activities, perform admirably and thereby play a part in maintaining FDIC as a viable insuror.

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Legislative Counsel

October 21, 1985

Honorable Jake Garn
United States Senate
Room SD505
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Garn:

By this letter I am responding to the questions regarding "deposit insurance reform" forwarded to CSBS by your letter of September 25, 1985. These responses are submitted on behalf of the Conference of State Bank Supervisors, as an extension of my testimony presented on July 31, 1985.

The questions submitted on your behalf and my responses thereto are as follows:

1. Should a federal insurance agency be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed institution with any profit after administrative costs arising from the transaction returned to the original stockholders?

Response: While CSBS supports greater flexibility for the federal insurance agencies, such as the type you have described, we believe that it should be exercised only where the primary regulator deems it appropriate. In any case, this type of authority should not be used in conjunction with or as a part of the emergency acquisition authority extended to the FDIC under section 116 of the Garn-St. Germain Depository Institutions Act of 1982.

As I stated in my direct testimony, CSBS would oppose attempts to amend section 116 of the Garn-St. Germain Depository Institutions Act of 1982 to allow the FDIC to arrange the sale of the assets of a "failing" bank rather than a bank which has been closed. First, such an amendment is unnecessary. State laws and regulations have provided adequate flexibility to arrange such transactions and, in several cases, have been specifically amended to accommodate

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the interests of the FDIC in handling failing banks. It must be remembered that the interest of the state in fashioning a timely and suitable remedy to a problem situation is at least as great as that of the FDIC, if not greater. Second, allowing the FDIC to, in essence, close a bank would be a severe breach of our system of bank chartering and regulation. It is the primary regulator, which grants the charter and is responsible to the public for performance under that charter, which ultimately bears the responsibility for the revocation of that charter and the closing of the institution. It is the primary regulator who is in the best position to pass judgement on the soundness of an institution, its potential for survival and its importance to the community. Third, allowing the insuror to close an institution may well lead to closing institutions for the wrong primary reason: protection of the insurance fund. While the FDIC asserts that the earlier a problem institution is closed or merged, the smaller the loss of the fund, this is not always the case. Broader public interests are served by our system of bank regulation and entrusted to the primary regulators of banks. These other objectives, including the rehabilitation of institutions, may well be forgotten by an agency with limited scope. There would obviously be great potential for the abuse of discretion in the determination of what is a "failing" institution or when such authority should be invoked.

The Supreme Court has recently reaffirmed that "banking and related financial activities are of profound local concern" and that "our country traditionally has favored widely dispersed control of banking." Through the McFadden Act and the Douglas Amendment to the BHCA, Congress has entrusted to the states the authority and the responsibility to safeguard our decentralized system of banking. The FDIC bears no such responsibility. The proposed expansion of the FDIC's authority to arrange the interstate sale of problem institutions must be understood to be the elevation of the protection of the insurance fund over other considerations which lie at the very heart of our banking system. Two competing Congressional policies are involved, reflected in grants of authority to two different agents. The grant of sole discretion to either agent elevates the policy it carries out above the other. Combined input and cooperation can ensure that those policies are both considered, as has been done to date.

2. If the burden of mismanagement were placed squarely on the managers and stockholders and most failures were handled through a purchase and assumption at an earlier stage - immediately or through a conservatorship - regard-

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less of size - wouldn't this dispose of the fairness question as it relates to large and small institutions? Why couldn't a Continental type solution be applied to failing small banks? If an insurance agency is funded totally by institutions is there a federal subsidy?

Response: Treating large and small institutions even-handedly would obviously dispose of a fairness question. Of course, as I noted in my testimony, since each failure situation presents a new set of particularized circumstances, each with its own problems, it is not possible to have a general rule as to the appropriate way to manage a failure. The purchase and assumption transaction is the preferred solution in most cases. Yet, this is not always the case. Judgements as to whether a problem institution can be restored to health or when to "pull the plug" are critical. Selection of the proper means of disposing of an institution require factoring in the respective interests of all segments of the public. There is nothing magical about a "Continental type solution," and the "solution" selected, like any other "solution," must be based on a judgement that it will fashion the desired end in a particular set of circumstances.

Any federal agency, created by Congress, operating as a part of the community of federal agencies and enjoying the full faith and credit backing of the United States Government and the "good will" of public perception which goes with it, enjoys a "federal subsidy". It is important, however, to draw a clear distinction between the insurance fund and the insurance agency. The insurance fund was created to protect depositors and to promote the stability of the banking system. Banks sustain the fund for these purposes.

3. Is there a place for self-regulation in the banking industry that draws on the talent within the industry? If so, how could concepts of self-regulation be included in the federal supervisory system?

Response: Self-regulation, on an institutional basis, appears most useful when performed by honest and competent management and audit staffs in a healthy institution during a period of market stability. As I stated in my testimony, the majority of bank failures have historically been attributed to fraud, improper loans to bank-related individuals and managerial weakness. The benefit of self-regulation in these instances is elusive. Self-regulation, on an industry basis, tends to be after-the-fact with regard to misconduct. Promulgation of industry standards may be

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helpful, but the absence of detection and enforcement mechanisms reduces their potential. Without the threat of Hell, the Ten Commandments would have been the ten guidelines.

4. What is your view of Mr. Keefe's suggestions that

a. The current loan limit is too high?
b. Many banks fail due to excessive concentration?
c. A bank be required to list its 30 largest borrowers by type of company?
d. The largest banks be required to supply regulators with monthly data?

Response: As I stated in my direct testimony, the majority of bank failures have historically been attributed to fraud, improper loans to bank-related individuals and managerial weakness. In cases where managerial weakness is the cause, an excessive concentration of loans to either individuals or sectors of the economy may be found. To an extent, these problems are fueled by the relatively high loan limits now in place.

State bank examiners do examine for excessive concentrations of loans and the largest borrowers are included in their analysis. However, if a bank is within its loan limits, very little can be done in instances where examiners find an excessive concentration of loans. A warning may be given to bank management, but it is often not heeded. The management decision to concentrate loans in a particular sector of the market usually reflects management's perception that the sector in question is stable and profitable.

The monthly submission of data is routinely required for banks in trouble. Imposing such a requirement on banks based on their size alone may be helpful in some instances, but may also provide a false sense of security within the regulatory agencies responsible for reviewing such data.

5. With regard to the concern that some states may have expanded banks product authorities beyond what may be prudent, can this issue be dealt with by giving the federal insurance agencies the authority to require a prudent level of capital to support that activity in order to maintain insurance - rather than giving any federal agency the authority to override a state legislature? In other words, wouldn't the adoption of risk-based capital standards go a long way toward solving this problem?

Response: The adoption of risk-based capital standards

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for banks could go a long way in mitigating the unwise and excessive use of state-granted product authority for institutions. It should be recognized that thrifts have been far more aggressive in their use of state-granted product authority than have banks and that thrifts have been responsible for most of the alleged excesses in the use of these authorities. As I have stated, the greatest difficulty with designing any risk-based system, is in determining the risk factors, as applied to individual institutions in different markets. The public benefits of such a system, however, appear to justify further attempts to develop a mechanism to take into account the market and the level of management skill, as well as the risk inherent in the activity in question.

In addition, states which have acted to increase state bank investment powers statutorily, have, generally, included some type of restriction on investments in that legislation. Also, states such as California and New York have drafted solid, comprehensive regulations to help curb excessive use of increased investment powers for banks.

The questions submitted on Senator Proxmire's behalf and my responses thereto are as follows:

1. You are opposed to disclosing cease and desist orders of the federal banking agencies. As you know, a cease and desist order is only taken when the regulator cannot secure the voluntary compliance of the bank's management. This indicates there is a fairly serious problem in the way the bank is being run.

If I am a depositor in that bank, why don't I have a right to know what is going on? If my banker had to be issued a formal cease and desist order by the federal government, I would want to know about it. By what principle would you deny depositors that important information?

Response: A cease and desist order is a legal tool and not a statement of a bank's condition. Such an order may issue for a variety of reasons some of which do not necessarily affect the soundness of an institution or its relationship to its depositors. A legal disagreement as to the scope of a bank's authority under state and federal law or a disagreement over the legal technicalities of certain bank practices may form the basis for such an order. It may issue where a disagreement has arisen over the timeliness or completeness of compliance with a memorandum or understanding.

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Because cease and desist orders may be based on points of technical or legal disagreement, it is subject to possible misunderstanding or misinterpretation. Ensuring accuracy by requiring verbatim reporting would not serve a valuable public information function; neither would the publication of mischaracterizations of what is occurring. A disagreement between a regulator and bank management does not always indicate that there is a fairly serious problem in the way a bank is being run or that a threat is posed to depositors. Yet, this may be implied in the publication of cease and desist orders.

CSBS is not opposed to the dissemination of meaningful public information, but does not endorse the concept of public disclosure as a supervisory tool and believes improper public disclosure would be counterproductive. As I stated in my direct testimony, CSBS recommends that if public disclosure must by used as a supervisory tool in the regulation of financial institutions, its requirements should emphasize deterrence rather than punishment for the institutions, be clearly understandable to and understood by the general public, be phased in on an orderly basis and should have uniform and consistent application to all types of financial institutions. Disclosure proposals to date have not been primarily for that purpose and/or have not met the aforementioned criteria necessary to meet the public interest test.

Also, as I have previously noted, requiring the disclosure of enforcement actions might actually work against improved bank supervision. The required disclosure of cease and desist orders could cause both state and federal regulators to withhold issuance in borderline situations to avoid possible inappropriate adverse public reaction as a result of disclosure. This would be extremely counter productive, since the proper use of cease and desist orders has been one of the most effective supervisory tools in recent years.

Further, in those money cases in which banks are managed and supervised back to health, disclosure of problems would be counterproductive to recovery efforts. Disclosure would tend to cause silent or noisy runs on banks.

2. Mr. Bailey, you argue that bank supervision is more an art than a science and that we should not apply rigid rules of thumb. Each bank is different. Thus a 6 percent capital ratio for one bank with strong management may be too high while it may be to low for another bank with the same

financial profile but with weak management.

I understand what you're saying, but it seems to me that as a practical matter, your approach is systematically biased in favor of the largest banks. How can a $25,000 a year bank examiner with one or two years experience substitute his judgement for a bank president making ten times that much with 25 years of banking experience. The federal banking agencies tried your approach for the last 50 years, and until Congress got tough in 1983, we saw a steady erosion in capital for the largest banks. Unless we have firm rules of thumb, arbitrary as they might be, are we not inevitably headed for lower and lower capital ratios for the larger banks with more and more risk being shifted to the FDIC and ultimately, the federal tax payers?

Response: The erosion of capital among all financial institutions is unfortunate. Therefore, the recent trend toward capital equalization, in essence, has been a positive step to establish capital adequacy. Equivalent minimum capital requirements for all types of institutions and for all sizes of institutions are desirable. Conceptually, it appears reasonable to treat such requirements as a floor, with upward adjustments of capital requirements made on a risk assessment basis.

My remark on the nature of bank supervision, made in regard to the difficulty inherent in risk assessment, remains valid. Risk is a function of macro-economic and micro-economic variables, of the effect of these variables on a particular activity within a specific market, and of the application of management skills and business judgement to all of the factors. It is true that the judgement of a single examiner cannot and will not be readily substituted for that of senior bank management. It is equally true that blanket assessment of risk would be essentially arbitrary and would discriminate against institutions which might profitably engage in an activity at little or no risk in a certain location. If a risk-related capital system is to be put in place, the development of an equitable risk assessment system must be a priority item.

3. As I read your testimony, you seem to be skeptical of risk based insurance premiums, but that if we are to move in this direction, the risk premiums should be determined by the bank's primary regulator. In the case of state-chartered banks, this means the state bank supervisor would be setting the premiums for the FDIC.

I have a little trouble with that concept. Every one

understands that the FDIC is an agency of the Federal Government and that ultimately, the U.S. Treasury and the Congress stand behind it. That being the case, why should the Congress delegate to the states the power to determine what premiums the FDIC is going to charge? If the federal government bears the ultimate financial responsibility, why shouldn't it also have the authority to set the premiums?

Response: Clarification of my written testimony is necessary. CSBS does not mean to suggest that state bank supervisors set the actual premiums for the FDIC. What is suggested is that each activity will vary in its risk factor, depending on variables such as location, capital or managerial skill and that the primary regulator is best situated to assess these factors on a case-by-case basis. As in most aspects of bank regulation, cooperation between state and federal regulators might be the best answer, with the FDIC doing an assessment of the element of risk inherent in the activity, the primary regulator assessing the localized factors, including bank management, and the FDIC ultimately setting the premium.

It is noteworthy that banks pay premiums to the FDIC both for deposit insurance and to ensure the stability of the banking system. If those premiums were to become a means of restricting bank activity, they may become prohibitively high for politically inexpedient activities.

4. a. On page 9, you say "protection of the (FDIC) fund, in and of itself, is not the primary goal of a failing bank exercise."

If protecting the FDIC fund is not the primary goal of closing a failing bank, what is the primary purpose?

b. Mr. Bailey, you are apprehensive of giving the FDIC sole authority to determine when a troubled bank should be closed. You argue that the public interest is broader than merely protecting the reserves of the FDIC. You say that the bank's primary supervisor is in a better position to consider these broader public interest concerns. At the same time, your statement is a little vague as to precisely what these broader public interest concerns are. Can you spell out with more precision what are these concerns and why you feel they are more important than protecting the solvency of the FDIC?

Response: The primary goal in a failing bank exercise is ensuring that the public needs and convenience are served on a continuing basis and, concomittantly, that public

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confidence in the banking system is maintained. Subsumed in these broad public interest concerns are a large body of considerations entrusted to the primary regulators of banks. These include matters such as local business and employment needs, community growth, diversity of institutions, local stability, local credit and service availability and broader considerations such as the operation of our capital distribution system and concentration of control over economic resources. Ignoring these considerations can have a very real cost, as real as the FDIC dollar cost, in a failing bank situation. These individual considerations can cumulatively effect the basic banking system of the community and the nation.

As I stated in my direct testimony, every effort is made to restore problem institutions to a healthy status and maintain their service to the community. There is a point, however, where the primary regulator can determine that the erosion of equity capital will continue unabated and that termination of the charter by the chartering authority is the least undesirable of existing options.

The "solvency" of the FDIC fund is not really in issue. The point CSBS would make is that it is often appropriate for the fund to absorb an incremental additional cost in order to maintain services in a trade area, public confidence in financial institutions and stability in the banking system. In mitigating the effect of bank failures, protection of the insurance fund, in and of itself, is not as important as avoiding unnecessary failures, which carry with them disruptions of services and shaken public confidence. It is noteworthy that the impact of bank failure on commercial borrowers through the disruption of established credit lines is often overlooked. I would reiterate that as in most areas of modern bank regulation, a great deal of cooperation is required between the primary regulator and the FDIC in serving these public interests.

Respectfully submitted,

Sidney A. Bailey
Commissioner of Financial
Institutions/Commonwealth
of Virginia

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National Association of
State Savings & Loan Supervisors
Voice of the State Chartered System
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The Honorable Jake Garn
Chairman
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator Garn:

Thank you for the opportunity to express the views of the National Association of State Savings and Loan Supervisors concerning deposit insurance reform. It was indeed a distinct honor and pleasure to be able to testify before the Committee on July 31, 1985. Deposit insurance reform is one of the most pressing issues confronting the Committee as it attempts to craft a legislative response to the problems facing the financial institutions industry. NASS&LS recognizes the significance of the Committees' role in addressing the widely held concerns regarding our financial institutions industry. NASS&LS applauds the Committees' efforts in this regard and offers its assistance in whatever manner might be appropriate.

This letter is intended to respond to the questions set forth in your letter of September 25, 1985 regarding the establishment by the State of Texas of a fund to supplement the Federal Savings and Loan Insurance Corporation. As stated in my prepared testimony, the "Texas Savings and Loan Supplemental Fund Act" was recently enacted by the Texas legislature as one response to the present situation in the savings and loan industry.

Q. 1. Your prepared statement makes reference to authority, recently approved by the Texas legislature, for the establishment of a savings and loan insurance fund. Is this facility similar to the insurance funds in Ohio and Maryland, which, as you know, have had serious finanical problems?

First, and foremost, it should be clearly understood that the newly created Texas supplemental fund is not similar to the now defunct private insurance funds in the States of Ohio and Maryland. The primary difference between the Texas supplemental fund and the Ohio and Maryland funds is that the Texas supplemental fund does not insure deposits, rather, it indemnifies the FSLIC while the FSLIC remains the insurer of deposits. The Texas supplemental fund will indemnify the FSLIC with respect to a

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particular state chartered savings and loan for a predetermined level of losses not to exceed $20 million. In order to be a member of the supplemental fund a state chartered association must have its accounts insured by the FSLIC. Unlike the Ohio and Maryland funds the administrator of the Texas supplemental fund is also the primary regulator of state chartered associations. I know that I am, and believe that any successor to the position of Commissioner of the Texas Savings and Loan Department will be, qualified to supervise the implementation and operation of such a fund, with its many benefits to the industry on a whole, and the consumers in the State of Texas in particular. The Texas supplemental fund is a well reasoned method of permitting state chartered member associations to engage in activities authorized by the Texas legislature while protecting the interests of the consumer.

Membership in the Texas supplemental fund is through an investment in the supplemental fund rather than the more traditional assessment of a premium. Each association which becomes a member of the supplemental fund will be at risk to the extent of its respective investment. Such a system lends itself to the creation of a self-policing system. Member associations will not permit reckless behavior and unwarranted risk to be assumed by a fellow member association without contacting my office. Once contacted, at a relatively early stage in the overall process I might add, my office can take appropriate action if such is required. The Texas supplemental fund will permit my office greater access to needed funds at a much earlier point in time to prevent a bad situation from getting worse. As I stated in my prepared testimony, inaction resulting from lack of information, lack of capacity to react or regulatorily built in impediments to action only foster the activities and dire results which we are all trying to prevent.

Q. 2. In your opinion, how will this supplemental fund contribute to the overall objective of building a sounder and safer savings and loan association system?

One of the primary goals of the supplemental fund concept is to preserve the assets of a particular association, not to protect deposits -- that responsibility can only rest with the FSLIC. In order for this increased safety and soundness in the savings and loan industry to be achieved the supplemental fund, any supplemental fund, must be accompanied by a supervisory apparatus which is capable of meeting today's needs. In this regard, the Texas legislature recently revised and recodified the Texas Savings and Loan Code in an effort to provide the Savings and Loan Department with expanded authority in dealing with institutions under its jurisdiction.

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Q. 3. What is the incentive for a state association to join this fund and to invest two percent of its assets at a return, which by design is below prevailing market rates for quality investments?

Membership in the supplemental fund will be induced by the ability of member associations to engage in the expanded powers granted by the respective state legislature. Legislatures must provide an incentive to savings and loan executives to meet and maintain financial and operational standards thereby opening the door to expanded activities. As mentioned in my prepared testimony the supplemental fund would preserve for member associations the asset powers and liability growth features granted to state chartered associations by the respective states, but within guidelines established by Congress. These inducements would more than offset the investment by member associations of 2% of assets in the supplemental fund. Additionally,the supplemental fund would be purely voluntary. However, if a state chartered association was not a member of the supplemental fund, it would not be permitted to engage in state authorized expanded powers. The practical result is that a state chartered association must pay for the right to participate in activities which are perceived to be riskier.

Again, as provided in my prepared testimony, if monitoring, examination and supervisory guidelines are achieved and minimum national standards relative to growth and diversification of assets are established, then it should be left to the respective state legislatures to determine appropriate lending and investment powers for their domestic savings and loans.

The contents of this letter are qualified by reference to my prepared testimony and the package describing the Texas Savings and Loan Supplemental Fund and related legislation and documents contained therein, both of which arcompany this letter.

Again, thank you for the opportunity to share with you and all the distinguished members of the Committee NASS&LS' thoughts and concerns and one state's attempt to deal with the serious problems at hand.

Very truly yours,

NATIONAL ASSOCIATION OF STATE
SAVINGS AND LOAN SUPERVISORS

L. L. Bowman, III, President

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The CHAIRMAN. If we could have the second panel come forward, please; Mr. Burns, Mr. Beason, Mr. Lapidus, and Mr. Artemenko.

Mr. Burns, if you would like to begin, please.

STATEMENT OF JAMES C. BURNS, JR., EXECUTIVE VICE PRESIDENT AND TREASURER, THE COOPERATIVE CENTRAL BANK, BOSTON, MA

Mr. BURNS. Thank you, sir.

Mr. Chairman, members of the committee, I would like to express my gratitude to you for inviting me to appear before your committee and rather than go through my written testimony on a point-by-point basis, I'd like to make some brief comments relevant to that written testimony and then answer any questions that you may have.

RESERVE FUND FOUNDED IN 1932

The Cooperative Central Bank's reserve fund was founded in 1932 to be utilized as a liquidity source by our member banks. As you well know, liquidity is normally the first need to be satisfied in the event difficulty occurs within any banking system. This fund is invested very conservatively in U.S. Government, U.S. agencies and similar securities and, in addition to being used for member liquidity purposes, it's also an income stream to our member banks.

Shortly after the founding of this fund in 1932, a share insurance fund was established. This fund continues to provide deposit insurance in full for all accounts in the cooperative bank industry. Both of these funds were established through acts of the Massachusetts Legislature and I believe is a prime example of a banking community, a regulator, and a legislature acting in conjunction with one another for the protection of depositors' funds.

We have a very proud and I believe enviable record inasmuch as no depositor in any cooperative bank in Massachusetts has ever lost a dollar. This was the case not only through the dark days of the depression but in the early 1980's when high-deposit rates were prevalent as deposit deregulation came on fast.

At this time our industry consists of 100 cooperative banks in Massachusetts with about 220 branches. The principal activity within our system for the past 20 years has been the granting of home mortgages and these comprise about 70 percent of our total portfolio.

With the changes which are occurring in banking over the past two decades, our member banks have provided additional services to our depositors like NOW accounts, auto loans, personal and student loans and the like. About 22 percent of our total assets are invested in U.S. Governments, municipals, Government agencies, and CD's. The net worth of our industry is about 7.6 percent of our deposit base.

Our fund was initially funded by an original assessment in 1934 and a special one in the mid-1940's. Each year the banks are assessed and the assessment for the past 13 years has been at the rate of one-twenty-seventh of 1 percent of deposits and notes pay-

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able. The assessment is determined by a vote of the board of the central bank and approved by our commissioner. By statute, the assessment could be increased to one-twelfth of 1 percent of deposits and notes. Once the coverage factor reaches the 3-percent level, we no longer assess. We do not assess on a risk-premium basis.

In Massachusetts, the asset powers within our system are pretty well set by statute inasmuch as the riskier, if you will, investments—that is, certain stocks and so forth—are related to a percentage of the total net worth of each institution, that is, no more than 2 percent of a particular type, no more than 5 percent of a particular industry.

If we find that somebody is misusing those powers, we tell them to put on the brakes. We act with early remedial action. If they do not put on the brakes, we change the drivers.

Each member bank, including the central bank, is subject each year to a regular occurring field examination by our State examiners and an audit by independent CPA's. All examination reports and audits are required to be sent to the central bank also for review. In addition, monthly reports are required by law to be sent to the central bank. These reports include balance sheet and income statement items together with delinquency reporting, commitments outstanding, liquidity data, and other selected important data.

A monitoring system would recognize any significant change occurring in these bank figures. Immediate telephone inquiry would be made and visitation by our staff and possibly banking department staff would be made post haste.

I might add that our coverage factor within our fund—fund assets to insured deposits—is about 2.5 percent with another 1.1 percent in our liquidity fund. We have seen other deposit insurance funds with high coverage factors. But the most important thing is the health of the insured.

In Massachusetts, the banking department has maintained a very conservative philosophy in its supervision and regulation of State-chartered banks. This supervisory approach has resulted in one of the strongest banking communities in America. The following guidelines may give you some idea. If a bank's capital ratio falls below 5 percent of assets, the bank is placed on a supervisory concern list. When it goes below 4 percent of assets, the board is directed to formulate and implement immediately a course of action which should include, but not be limited to, seeking a merger partner or raising additional capital. When the ratio falls below 3 percent, the certification of the bank as unsafe and unsound is imminent.

EARLY WARNING SYSTEM

In addition to these capital requirements, we also monitor variations in any of the classifications in our early warning system. There have been instances where we have taken action with banks of relatively high net worth when a deterioration trend has been diagnosed in one of these categories. This policy of early remedial action has been successful in preventing deterioration of the bank's

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financials and for the maintenance of one very important factor—public confidence.

We have been able to assist a number of banks over the past utilizing our ability to restructure, merge, provide income streams, along with administrative and financial assistance purely from the income from the fund. The principal of the fund has not been used. And through the difficult period of the high interest rates of the early 1980's, the fund has continued to grow successfully each year.

It should be noted that since 1980 the central bank has furnished financial assistance to member banks to facilitate these mergers or to assist in asset restructuring. None of these cases involved insolvency but, rather, were cases of early detection.

About 42 of our member banks are members of the Federal Home Loan Bank System and use that as a source of liquidity. In addition, all of our banks have all provided documentation to the Federal Reserve Bank of Boston for future liquidity needs. Since the Maryland and Ohio situations, we have concluded in the interests of our depositors, our boards of directors, our management teams, that we should indeed seek Federal insurance. We are in that process right now and a number of our banks are being examined by FDIC examiners.

We are opting for the FDIC for a number of reasons. First of all, in Massachusetts the recognition figure for FDIC is far more prevalent than FSLIC. Also, our sister industry, the savings bank industry, in Massachusetts has FDIC insurance and has coinsurance and it works, from my observations, very well with the FDIC. We understand from discussions with the FSLIC that dual insurance would not be permissible for FSLIC-insured institutions or could not be advertised and would probably have to be phased out after 5 years. We find this to be a marketing detriment in Massachusetts and we don't want it.

As far as private insurance is concerned, as I say, we are opting for the FDIC. We intend to and it is our desire to work with the FDIC to coinsure. We are a very healthy industry. We have a very, very healthy insurance fund and I think we would be a very attractive industry for the FDIC. The public in Massachusetts has been told by its legislature and it is a statute within our Commonwealth that deposits will be insured in full and it our intent to insure them in full.

Thank you very much.

[The complete statement follows:]

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STATEMENT OF JAMES L. BURNS, JR., THE CO-OPERATIVE CENTRAL BANK, BOSTON, MA

Mr. Chairman, and members of the Committee, initially I would like to express to you my appreciation for the opportunity to address this committee relative to the subject of deposit insurance. I would like to begin by providing you with some background on the operation of the Co-Operative Central Bank which is a source of liquidity and is the deposit insurer for the 100 co-operative banks in the Commonwealth of Massachusetts.

The Co-Operative Central Bank's reserve fund was founded in 1932 to be utilized as a source of liquidity by our member banks. As you well know, liquidity is normally the first need to be satisfied in the event difficulty occurs within any banking system. The reserve fund has been maintained and increased since inception in 1932 and has continued to be utilized by our member banks to meet their occasional liquidity needs.

The leaders of our industry recognized at that time the need for the existence of a deposit insurance fund in addition to the liquidity fund. Our industry implemented the share insurance fund in 1934. This fund is a prime example of the banking community, the banking department and the legislature acting in conjunction with one another in the Commonwealth of Massachusetts.

As a result of these two funds, a very strong, confident, conservative and well-regulated industry evolved. Our depositors have never lost any money nor ever had any difficulty in obtaining their funds at any of our co-operative

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banks, even during the depths of the depression. This service to our customers continues to exist.

At this time our industry consists of 100 state chartered co-operative banks with total assets of $5 1/2 billion and total net worth in excess of 7.6% of deposits. There are 220 co-operative bank offices throughout the Commonwealth. The principal activity within our system for well over 100 years has been the granting of home mortgages. These mortgages comprise nearly 70% of our total asset base. With the changes which have occurred in banking over the past two decades, our member banks have provided additional service to their depositors, such as NOW accounts, auto loans, personal, student and home modernization loans, ATMs, and Keogh and IRA retirement accounts. In addition, 22% of our asset base is invested in portfolios which consist primarily of U.S. Government securities, U. S. Government Agency Bonds, CDs and FED funds. Our industry is a stable one - community banks service community needs. They are not involved with brokered CDs or out-of-state repurchase agreements.

At the Co-Operative Central Bank we have approximately $170 million in reserves, and over $60 million in lines of credit with Boston, New York and Washington, D.C. commercial banks. One additional strength within our system is the diversification of risk. The average size of our member banks is approximately $50 million in assets. Only twelve are over $100 million, none have deposits in excess of $300 million, and our

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two largest institutions each represent only 6% of the total assets of the industry.

The methods of obtaining moneys for our reserve fund and insurance fund differ somewhat. In our reserve/liquidity fund, deposits are adjusted annually as the result of a vote of the Board of the Co-Operative Central Bank. A dividend is paid on these moneys. Because of the good earnings of the fund, that dividend has been at the rate of 12% for the past number of years. It acts as a source of liquidity for member banks, as well as an additional income stream.

The share insurance fund was initially funded by a capital assessment in 1934 and a special capital assessment in the mid-1940s. Besides those early capital assessments, annual premiums have been used as a source of the fund's financial resources. Each year the banks are assessed a premium - for many years that assessment has been at a reduced rate of 1/27th of 1% of deposits and notes payable. This assessment is determined by a vote of the Board of the Co-operative Central Bank and is subject to the approval of the Commissioner of Banks. By statute, the assessment could be increased to 1/12th of 1% of deposits and notes payable. Once the coverage factor of the share insurance fund alone is 3% of deposits, no further assessments would be made unless the coverage factor fell below 3%.

Each member bank, and the Central Bank, is subject to regular recurring field examinations by the State Banking Department and an audit by independent public accountants. All

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examination reports and audits of member banks are required to be sent to the Co-Operative Central Bank for review. In addition, monthly financial reports of member banks are required by law to be sent to the Co-Operative Central Bank. These reports include balance sheet and income statement items together with delinquency reporting, commitments outstanding, liquidity data and other selected important data. Our monitoring system would recognize any significant change occurring in these bank figures. Immediate telephone inquiry and/or visitation by Central Bank staff, and possibly banking department staff, would occur.

In Massachusetts, the banking department has maintained a very conservative philosophy in its supervision and regulation of state chartered banks. We also have in Massachusetts a state legislature which has wisely placed limitations on the amount of borrowing and also on the total amount of any one particular loan or investment to any one individual. These legislative and supervisory approaches have resulted in one of the strongest banking communities in America. The following capital guidelines, established for a number of years by the Commissioner of Banks, serves as a good example of a strong, conservative approach:

"If any Bank's capital ratio falls below 5% of assets the bank is placed on a supervisory concern list, when the ratio falls below 4% the Board is directed to formulate and implement immediately a course of action which should include, but not be limited to, seeking a merger or raise additional capital. When

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the ratio falls below 3% the certification of the bank as unsafe and unsound would be imminent."

In addition to these capital requirements, we also monitor variations in any of the classifications (for example, interest income or expense) in our early warning system. There have been instances where we have taken action with banks of relatively high net worth when a deterioration trend has been diagnosed in one of these other categories. This policy of early remedial action has been successful in preventing deterioration of the bank's financials and for the maintenance of a very important item - public confidence.

Since 1980, the Co-Operative Central Bank has furnished administrative and financial assistance to fourteen insured members to facilitate mergers, or to assist in asset restructure. None of these cases involved insolvency but were cases of early detection and prompt remedial action to maintain banking system safety and soundness. Moreover, the financial assistance has been purely from the income from the insurance fund. The principal of the fund has not been used, and through the difficult period of high interest rates and deregulation in the 1980, the fund has continued to successfully grow each year.

Examples of such financial assistance include the following:

1. Permanent capital of $1,950,000 was disbursed to two institutions.

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2. Interest bearing loans of $3,529,670 were advanced to three institutions. Current outstanding balance of $899,670 exists.
3. Capital certificates of $16,724,000 were issued to four institutions. $13,819,700 remains outstanding presently.
4. Securities of $10,065,000 were acquired from one institution at book value. $8,731,700 remains outstanding subject to resale on 4/21/87.

In order to attain this enviable record it is of the utmost necessity that the regulator and the insurer work together. Since assuming my responsibilities at the Co-Operative Bank some twelve years ago, I have worked with four State Banking Commissioners in Massachusetts and, am very proud to say, have worked well with each and every one, enabling us to fulfill our duties as the watchdog and insurer of our industry. The examination, audit and reporting process, together with visitations by personnel of the Central Bank, enable us to keep a very close scrutiny of our banks' performance, thus enabling the safety and soundness of our industry.

Forty-two of our member banks are also members of the Federal Home Loan Bank system and, as such, have access to their discount window. We in the Massachusetts thrift business have been very reluctant in the past to borrow. However, the opportunity is still there should we need it. The average

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borrowing in the recent past for our over $5 1/2 billion industry has been approximately $60 million.

Your letter of invitation to appear before this Committee suggested that I comment on deposit insurance in general. Since the adverse situation in Ohio, and then another in Maryland, there is a growing feeling among our members that our depositors and the general public have a perception that federal deposit insurance is something which would inspire more confidence in our system. Our members have always had the ability to obtain FSLIC insurance. However, over our 50-year history, the adoption of that insurance by any of our state chartered member banks occurred only once, in 1956. That one institution was a member of the FSLIC for only one year and then it returned to our deposit insurance plan. The only other exceptions occurred when two of our institutions obtained federal deposit insurance as part of the process of converting to federal charters. However, because of the present scenario, we feel that to retain the confidence of our depositors the adoption of federal deposit insurance for all of our members is important. To that end, our industry has been in the process of seeking to obtain federal deposit insurance. As I mentioned, we have the statutory and regulatory ability to obtain FSLIC insurance. However, it is our strong feeling that FDIC would be the more attractive route for us to follow for a number of reasons, including the recognition factor of FDIC being much higher in the Northeast, and our sister industry, the savings banks of Massachusetts, will also be FDIC-insured.

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Our banks' own strong liquidity positions, substantial lines of credit, the membership in our own reserve/liquidity fund, access to the federal reserve discount window pursuant to the Monetary Control Act of 1980, the overall strength of our industry and a very strong Co-Operative Central Bank -- all these factors have been adequate to safeguard our depositors' funds. The adoption of federal deposit insurance will further enhance that.

I would like to stress to the Committee once again that even through the traumatic experience of the '30s and early '80s not one co-operative bank has ever failed, not one depositor has ever lost a dollar in our system, liquidity has always been maintained and all deposits have been insured in full.

Without further delay, I will address some of the specific issues included in the Committee's guidelines for witnesses. My comments are as follows:

1. Can we improve our ability to assess the condition of financial institutions?

   I feel that ability may be improved by better use of existing data and personnel. Consistency and comparability are essential in analysis. Existing analytical techniques are sufficient to detect or discover problems. Current overemphasis on quantative data for computer analy-

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sis has, in my opinion, lessened the subjective review process.

Changing or adding reporting requirements, except where absolutely necessary, would be counterproductive. Problems have gone undetected or uncorrected with existing data and personnel. The past and current changes in data, personnel, and analysis techniques may, in my opinion, already have delayed corrective action or discovery of problems in financial institutions.

The Committee's letter asks whether predicting failure would improve our ability to assess the condition of financial institutions. This question suggests that you permit failure and, thus, permit conditions to exist that will result in failing. I recommend that the Massachusetts example be followed -- take early remedial action to correct problems and avoid the later and more expensive failure process.

2. Based on condition, size or other criteria, how should laws and regulations differentiate between institutions? What roles do disclosure,

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enforcement, and risk-based assessments have in the insurance system?

Reduced requirements or waivers of certain requirements should exist for institutions of smaller size, when certain stable conditions exist in capital, earnings, and operations.

With regard to the role of disclosure in bank supervision, I strongly feel that early remedial action with confidential written agreements or understanding between the bank, its regulator, and its deposit insurer are more effective. Due to the public confidence factor in banking and with existence of deposit insurance, disclosure must be accomplished discreetly.

Supervision is enhanced by strong enforcement powers. Certainly guidelines describing such powers and clearly outlining the rights of parties involved in agency enforcement actions should exist, but general or blanket enforcement power or policy should also exist so that a regulator and/or deposit insurer may take whatever effective and expeditious action it deems necessary to protect depositor funds.

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With regard to risk-based capital, there appears to be no need to reinvent the wheel, but rather the brakes should be utilized earlier or removal or change in drivers should be made early on. Capital or surplus and net sound capital or surplus should continue to be objectively and subjectively analyzed. Both asset risks and off-balance sheet liabilities should be considered in net sound surplus. Unsafe or unsound practices, concentrations and contingencies should be noted, analyzed and corrected if excessive or unsafe.

Another risk-based concept which has been discussed as a new insurance tool is risk-based deposit insurance premiums. I do not believe that risk-based deposit insurance can be made operational. High risk connotes an unsafe or unsound practice being permitted to continue. This is gambling, not bank supervision. The delay in taking corrective supervisory action will in all probability result in a higher expense to the deposit insurer and ultimately to the banking system itself. Premiums for high risk would have to be 100% or more -- an excessive and non-operational amount.

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2. When should institutions be closed, merged or assisted?

Early diagnosis and correction of financial problems should be the mode. Closings should be avoided to the greatest extent possible. Closings undermine public confidence in the overall system and are extremely expensive to the deposit insurer, the surviving institution (if any) and to the entire banking system. If a closing is necessary, it should be done early as part of the corrective action agreed to by the relevant parties (regulator, insurer and bank to the extent it is willing and/or cooperating with outside authorities). In early diagnosis and corrective action programs, such as exist in Massachusetts, the bank or its deposit insurer may have been given the responsibility or the authority to seek a merger partner as part of an assistance agreement.

Capital or cash infusions should be provided by an insuring agency as part of an assistance agreement when corrective action has been agreed to by the relevant parties (regulator, insurer, and bank) and a plan of action is reasonable and acceptable to the regulator and the insurer. In

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our situation, this remedy has been very successful. We have established covenants between ourselves and assisted banks which provides them with the capital or cash infusion and permits us to closely monitor their activities for the provisions and payback of these monies once they attain certain levels of net worth.

When institutions need funds, the Federal Reserve is a source of secured borrowing. Present Fed procedures and collateral requirements should suffice. Immediate access by deposit insurer in emergency situations should also be part of such procedures. Uniform state or regional treatment in this regard is essential.

4. Is there a role for private insurance and, if so, should or can that role be facilitated?

In my view, excess deposit insurance or co-insurance will be the most likely role. Private insurance with Federal insurance guaranty should also be considered. In Massachusetts it is a statutory requirement that our deposits be insured in full. We will, as the Massachusetts Saving Bank industry has done, co-insure our

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depositors' funds, including the excess over the Federal deposit insurance limitations, (currently at $100,000). I should also state that the Cooperative Central Bank provides other services to our industry.

As I mentioned previously, we have our insurance fund. We also have a liquidity fund. We also are in the process of setting up an investment fund and we are considering the provision of directors and officers liability insurance and blanket bond insurance. Thus,. the character of our business may change, but our continuing commitment to provide financial services to our members will not.

Again, I express my appreciation to this Committee for the invitation to me to testify before it.

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The CHAIRMAN. Thank you, Mr. Burns.
Mr. Beason.

STATEMENT OF DONALD R. BEASON, PRESIDENT, FINANCIAL INSTITUTIONS ASSURANCE CORP., RALEIGH, NC

Mr. BEASON. Thank you, Mr. Chairman. My name is Donald R. Beason and I'm president of the Financial Institutions Assurance Corp. of Raleigh, NC.

Mr. Burns, Mr. Lapidus, and the others witnesses will address some of the possible roles of private deposit insurance, and if you will allow my written statement to be included in the record I will just touch on a couple of points.

The CHAIRMAN. It will be.

Mr. BEASON. The first of which, based on some of the things already said before this committee by a number of other people, is the ability to predict failure. It seems that is a big question and I think the answer to that question is, yes, you can predict failure.

QUALIFIED REGULATORS NEEDED

This would be a good time to point out that the problems of bank and savings and loan failures are not directly because of concentrations, or bad loans, or farm loans, or foreign loans, and not because of deregulation, but because of management, which is what I would call the problem, and it must be addressed. The regulators must be willing and able to judge management risk.

For example, there are some well-qualified financial institutions with well-qualified people working in them who know how to make real estate investments, and they should be allowed to so invest if they can do it safely. There are, however, some people in some institutions who are not qualified to do those things and regulators should not allow them to do them.

Adequate capital and good management in institutions and more effective regulation are the long-term answer to our problem.

With regard to the idea of risk-based deposit insurance, there are 1,000 reasons people give as to why it can't be done. In my opinion, there is only the simple statement that it should be done, it must be done, and, quite frankly, it can be done. Somebody simply has to be willing to make the decisions.

Our operation in North Carolina is presently going out of business. All of the institutions that we insure in four States are seeking Federal insurance. However, we were successful about 3½ years ago in implementing risk-based cost for the product that we offer. It included management risk, which is not easy to do. It takes talent to do that, it takes willingness to do it, and you've got to be willing to be wrong. I would relate the problems of risk-based premiums to the risk-based capital idea, and in my written testimony I have set out some examples on how that could be addressed. The Congress needs to delegate to regulatory authorities the power to establish effective standards in these areas.

Risk-based capital and risk-based premiums. Congress must give the regulators the right to be wrong the first time. Industry must give them the right to be wrong the first time. We know the prob-

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lems, and now we have long-term solutions that need to be addressed and that a risk-based program is one of them.

I would be glad to try to answer any questions.

The CHAIRMAN. Thank you, Mr. Beason.

[The complete prepared statement follows:]

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STATEMENT OF DONALD R. BEASON, PRESIDENT, FINANCIAL INSTITUTIONS ASSURANCE CORP.

Mr. Chairman and members of the Committee, I thank you for this opportunity to testify and I want to compliment you, Mr. Chairman, on the outstanding staff you have assembled. This Committee has shown that it is willing to take on some tough assignments and get things done. You are to be commended.

In response to your invitation to testify, I shall attempt to address the four (4) basic questions presented for comment.

CAN WE IMPROVE OUR ABILITY TO ASSESS THE CONDITION OF FINANCIAL INSTITUTIONS?

YES! But you must first build into the Regulatory system the ability to change. The tools of yesterday will not work today and those needed today will not necessarily work tomorrow. I understand that Banks are today moving away from international lending and going to Note Issuance Facilities and Interest Rate Swaps. So as the regulators are just understanding the problems with foreign loans, the industry is leaving that area and moving to another new and little understood field. Are the regulators ready today to deal with Note Issuance Facilities? I doubt it and I understand these have gone from just two and a half billion dollars in all of 1983 to over twenty-three billion dollars in the first half of 1985.

MORE TIMELY DATA

Information should be presented and analyzed on a monthly basis. Too much can happen too fast to do otherwise.

Mr. William M. Isaac, Chairman of the FDIC, stated in his most recent appearance before this Committee that the changes taking place in the financial system are revolutionary and the central question is not whether change will or should continue but rather how to insure that the financial structure that eventually results will best serve the public interest. He also stated that a deregulated environment is more complex and faster paced.

Mr. John Ryan, former Head of Supervision at the Federal Reserve, testified of inordinate delays encountered in any attempt to collect new data or to modify existing reports...delays encountered were insurmountable in any reasonable time frame. He placed the blame on your Paperwork Reduction Act and agency procedures.

Regulators must be willing and able to change with the environment for which they are responsible.

IMPROVED ANALYTICAL TECHNIQUES

With today's technology, analytical techniques are available to do just about anything one desires. For example, currently, most data is presented on a one time period basis. I have found that reviewing financial data over a period of time is extremely helpful as a tool to spot potential trouble. An example of a time trend report is presented for your review:

YIELD INFORMATION — RATES ARE STATED AT UNKNOWN RATE

TREND REPORT FOR APR 85

	CURRENT SPREAD	HISTORICAL SPREAD	BREAK EVEN YIELD	BREAK EVEN YIELD(OPER)	YIELD MTG/LN	YIELD CONS/LN	YIELD COMM/LN	YIELD INVEST	YIELD EARNING ASSETS	COST OF SAVINGS	COST OF BORROWED	TOTAL COST OF $
MAR 84	2.09	.21	9.74	9.89	12.95	15.61	12.95	11.11	12.67	10.57	0.00	10.57
APR 84	2.34	.36	9.97	9.33	12.20	16.20	12.20	11.10	12.04	9.70	0.00	9.70
MAY 84	3.21	.53	9.08	9.55	13.40	14.30	13.60	11.30	13.31	10.10	0.00	10.10
JUN 84	2.42	.41	9.35	10.01	12.60	17.90	12.60	11.60	12.62	10.20	0.00	10.20
JUL 84	3.07	3.53	9.87	13.36	13.60	14.10	13.60	11.70	13.47	10.40	0.00	10.40
AUG 84	2.29	3.72	9.36	12.76	12.90	15.90	12.90	11.90	12.90	10.60	0.00	10.60
SEP 84	1.20	3.16	9.50	12.57	11.20	15.60	11.20	13.50	11.70	10.50	0.00	10.50
OCT 84	2.85	3.35	10.18	13.53	13.40	16.00	13.40	13.70	13.65	10.80	0.00	10.80
NOV 84	3.05	3.33	9.81	13.57	13.80	15.60	13.80	10.80	13.76	10.70	0.00	10.70
DEC 84	3.00	3.49	9.96	14.37	13.82	16.00	13.82	11.66	13.91	10.90	0.00	10.90
JAN 85	3.53	4.44	9.72	15.10	13.85	16.05	13.85	11.76	14.11	10.58	0.00	10.58
FEB 85	4.16	4.51	9.35	15.14	13.91	16.03	13.91	11.61	14.27	10.10	0.00	10.10
* MAR 85	3.61	4.61	10.25	14.14	13.96	16.00	10.00	12.00	14.33	10.65	11.00	10.71
APR 85	4.30	4.80	10.02	16.04	14.01	16.00	14.01	12.00	14.62	10.08	11.00	10.31
GROUP MEAN	2.20	2.34	9.66	11.33	11.67	12.66	11.82	9.84	11.39	9.17	9.01	9.18
MEMBER MEAN	2.93	2.88	9.67	12.92	13.27	15.96	12.99	11.61	13.36	10.42	11.00	10.44
MEM STD DEV	3.00	6.23	1.40	8.63	2.95	2.68	4.22	3.02	3.19	1.22	0.00	1.18

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This is the type of information and format that should be analyzed by well qualified financial analyst on a monthly basis. If and when potential trouble is spotted, that information should go to a well qualified field analyst who goes on site equipped with a portable computer and the software necessary to follow up with great detail in the areas of concern.

The key point is to identify the problem. Too often we spend our time on the symptoms and not the problem. After the problem is identified, then the questions are: What information is needed? In what form? And who will interpret? I can tell you that the answer to those questions will change frequently and every financial regulator must be prepared to change as needed.

ADDITIONAL SOURCES OF INFORMATION

Should be other regulators. Too often we find that one financial regulator will not even talk with another. If that problem cannot be solved, you, the Congress, should consolidate them.

THE ABILITY TO PREDICT FAILURE

Lies with the quality of information and the quality of people. The answer to the question is Yes, you can predict failure. This would be a good place to point out that high risk activities, bad loans, loan concentration and all the other reasons given for the failures at Banks and Savings and Loans are symptoms. Those investments did not just show up, they were made or approved by **MANAGEMENT**, which I would call, the problem. Regulators must judge management as a risk. There are some well qualified people in financial institutions that can safely do real estate development, but most simply do not know anything about that field and they should not be allowed to do it, if someone else (FDIC, FSLIC) is taking the risk.

THE QUANTITY AND QUALITY OF PERSONNEL

This is where you get to the heart of the solution. You can gather all the data, in whatever form, but if you do not have the people to accurately interpret that data and act on it, you just have a lot of paper. In the old days of close regulation, examiners with twenty (20) hours of accounting were sufficient. Today, you must have MBA's, CPA's, and Lawyers in the field who are then trained and equipped to handle specific areas of potential concern.

The regulatory agencies should be headed by people who are long term thinkers, who are not afraid of change, but are constantly prepared to meet and deal with change. The financial industry has changed, is changing, and will continue to change.

Regulatory leaders must get results with things as they are today and be prepared to get results when things change.

However, given the best of leaders and staff, the regulators cannot do the job with the present constraints placed on them by the Congress. The Congress should give broad powers and flexibility to financial regulators.

BASED ON CONDITION, SIZE OR OTHER CRITERIA, HOW SHOULD LAWS AND REGULATIONS DIFFERENTIATE BETWEEN INSTITUTIONS?

Laws should delegate to the appropriate regulatory authority broad powers to take any actions necessary for reason of safety and soundness.

Regulations should be written so that regulators can treat everyone different. Current regulations do not allow that flexibility and to be successful, you must realize that every situation is different and it must be handled based on the facts in place with each one.

Laws and regulations must recognize that not everyone "doing his thing" has a constitutional right to insurance of accounts.

DISCLOSURE has no role. That is unless someone wants to challenge the rights or power of a regulator, then they can go to the courts where disclosure will take place.

ENFORCEMENT ACTIVITIES: Policy guidelines should allow for any action necessary in order to protect depositors. A proposal is set forth below:

Supervisory Action

When, in the opinion of the District Supervisory agent or the Board, a Member is operating in an unsafe or unsound manner, the Corporation may take any actions it deems necessary to properly safeguard the Depositors of the Member. Actions taken by the Corporation may include, but are not limited to, the following: (i) requiring changes in, or the Corporation's prior approval of, any aspect of the Member's operations; (ii) appointing persons to or removing persons from the Member's Board of Directors; (iii) removing officers or placing officers on leave of absence; (iv) employing accountants, attorneys, appraisers, consultants or any other professional, the reasonable cost of which is to be paid by the Member, to review or modify any of the operations of the Member. The actions which the Corporation may take pursuant to this section may be initiated and implemented by the District Supervisory Agent, with the exception of those actions specified by

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(ii) and (iii), which may be implemented only after approval by the Board.

Any institution, upon becoming a Member of the Corporation, agrees under the foregoing circumstances, to make such changes and take such actions as may be required of it by the Corporation.

The Corporation shall notify a Member in writing of any changes it must make or actions it must take pursuant to this section. Such Member must, within fifteen days of the date of the notice or such other time period, not less than fifteen days, stated therein, comply with the actions or request a hearing. Such hearing shall take place within fifteen days of the Member's written request therefor and the Corporation shall act within fifteen days of the convening of the hearing. The Member must comply with the action unless the Board rescinds or modifies the actions. If the Board modifies the action, the Member must comply with the action as modified. The Board may notify the Member that its membership in the Corporation will be terminated if the Member fails to comply within the time stated in the notice.

RISK BASED CAPITAL: SHOULD CAPITAL STANDARDS BE APPLIED TO OFF BALANCE SHEET LIABILITIES? Yes! Without question the answer is Yes!

SHOULD CAPITAL LEVELS BE BASED ON AN ANALYSIS OR RISK IN THE PORTFOLIO?

Yes! Capital requirements should be set by the regulators (FDIC, FSLIC) and those requirements will change from time to time. In the example I have included here, percentages have been assigned to specific assets for the purpose of illustration only. I am sure the FDIC and the FSLIC can do this with little difficulty and if they do not now have the authority, they should have.

The level of the capital account which shall be established and maintained against assets is fixed as the following percentages:

1. *zero percent for the following "Group One" assets:*

   (A) Stock in the Federal Home Loan Bank;
   (B) FSLIC secondary reserve, and;
   (C) Unencumbered land and fixed assets used in course of the association's business.

2. *two percent for the following "Group Two" assets:*

(A) *investments eligible for liquidity,except those assets in #1.*

3. *three percent for the following "Group Three" assets:*

   (A) *variable rate, single family residential mortgage loans and mortgage-backed securities;*
   (B) *loans on withdrawable accounts;*
   (C) *premiums or discounts on mortgage loans to be amortized.*

4. *five percent for the following "Group Four" assets:*

   (A) *variable rate commercial loans*
   (B) *secured variable rate consumer loans;*
   (C) *loans to facilitate; and*
   (D) *investment in service corporation.*

5. *eight percent for the following "Group Five" assets;*

   (A) *any fixed rate loans with maturity in excess of 21 months;*
   (B) *unsecured loans;*
   (C) *real estate owned;*
   (D) *standby, fixed-rate, long term commitments in excess of six months at time of issuance;*
   (E) *loans in bankruptcy; and*
   (F) *other liabilities, on or off the balance sheet.*

Upon review of an institution's assets and for just cause, the regulator may require an amount of capital in addition to the amounts prescribed in this Rule. Just cause shall include but not be limited to an institution's ability to manage its assets.

RISK BASED DEPOSIT INSURANCE: HOW CAN THIS BE MADE OPERATIONAL? Delegate to the supervisory authority the broad powers to implement it.

HOW SHOULD DEPOSIT PREMIUMS BE ASSESSED IN TODAY'S ENVIRONMENT? The same as in any other environment. It must be based on the risks in each individual institution as defined by those taking the risk (FSLIC and FDIC).

These risks will change from time to time. A couple of years ago it was interest rate, now it is asset quality. Both of the above

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are a direct result of Management risk. Yes, the supervisory authorities must be able to judge management risk.

Risk must be identified and a proper fee charged for the risk involved. This should be done by people at the district level of the supervisory agency. It cannot be done by the Congress.

AT WHAT POINT SHOULD AN INSTITUTION BE CLOSED?

Each case must be worked and decided on a case by case basis. Closing an institution should be the last thing done. Closing institutions is the one thing that causes the public to lose confidence in our banking system.

WHEN AN INSTITUTION FAILS, WHAT SHOULD THE PUBLIC POLICY GUIDELINES BE WITH REGARD TO MANAGING THE FAILURE THROUGH MERGER, PURCHASE AND ASSUMPTION, CONSERVATION, OR LIQUIDATION?

Do whatever is necessary to protect depositors. That broad authority should be delegated to the appropriate supervisory authority. Again, each case will be different and should be managed as the facts dictate.

SHOULD A SUPERVISOR BE GIVEN THE ABILITY TO REQUIRE MERGER PRIOR TO BOOK INSOLVENCY?

Without question, Yes!

WHEN SHOULD THE INSURANCE AGENCIES PROVIDE CAPITAL OR CASH INFUSIONS TO INSTITUTIONS?

When all else fails and then only with competent management in place.

HOW CAN THE BIDDING PROCESS BE IMPROVED AND THE COST OF MANAGING A FAILURE REDUCED?

Merge or sell them before they are total failures.

Get rid of the laws that put constraints on what, when and where the regulators can act. For example, requiring the FSLIC to follow the in-state like kind, out-of-state like kind, in-state different kind, etc. requirements. When you have a potential failure, and your goal is to protect depositors, why care if an S&L is bought by a Bank? These potential failures need capital and management. If Banks can provide it, let them.

SHOULD THE FDIC AND FSLIC BE MERGED?

If financial institutions are to be the same, yes! If, however, savings and loans are to be different from Banks, no!

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A proper Federal regulatory structure for financial institutions would be: The Federal Reserve System to handle monetary policy, charter, and regulate National Banks; The Federal Home Loan Bank Board, housing policy and the FDIC-FSLIC with complete responsibility and authority to regulate for safety and soundness.

WHAT GUIDELINES SHOULD EXIST WITH REGARD TO ACCESS TO THE DISCOUNT WINDOW?

Under the circumstances that exist today, those guidelines in place appear to be sufficient. If the system or the need changes, it may be necessary to change the Fed's lending policy.

IS THERE A ROLE FOR PRIVATE INSURANCE?

Yes! As a provider of excess coverage on amounts over that in place by the federal insurers.

This program should be a pure financial guarantee product offered only to those institutions that met and continue to meet the requirements of the insurer.

Our research indicates a need and a desire for this product and we are currently attempting to design a plan which would be financially sound and affordably priced.

Excess deposit insurance would benefit the consumer because he would have protection on a greater amount. We will soon see a large number of IRA and Keogh accounts with over $100,000, those accounts should be fully insured. The institution would benefit by being able to retain local deposits. In areas like Wyoming, which has very small local banks, customers are sending their excess deposits to out-of-state or out-of-town banks in order to have their money fully insured.

Excess insurance would be good for the system by promoting safety and soundness because a private insurer would cancel if it saw a risk it was unwilling to take. It should be recognized that not all institutions would qualify for private coverage.

Excess deposit insurance makes sense if it is designed to protect the personal saver and small business. I do not see it as a vehicle to provide coverage for the $10 million dollar foreign depositor.

Is there a role for private deposit insurance as a primary insurer? I do not think so. The reason is a complete loss of public confidence because of Nebraska, Ohio and Maryland. Those problems were a direct result of inadequate management of those funds by their Boards of Directors. We would normally look for that lack of confidence to fade over a period of time, but I am

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afraid there are other private funds that are similarly managed and additional failure can be expected. I do not place all private insurers in that category. There are those that are strong and well managed. They do a good job for the market they serve.

I again would say that there should be national standards for private deposit insurers and the National Association of State Credit Union Supervisors is to be complimented for its effort to do that for the private insurer of credit union deposits. We called for national standards for private deposit insurance years ago, but most in the business were opposed and would not cooperate in that effort.

Thank you again for the opportunity to meet with this Committee.

The CHAIRMAN. Mr. Lapidus.

STATEMENT OF LEONARD LAPIDUS, EXECUTIVE VICE PRESIDENT, MUTUAL SAVINGS CENTRAL FUND, INC., WOBURN, MA

Mr. LAPIDUS. Thank you, Mr. Chairman. I appreciate the opportunity to testify. I am going to focus my comments on the value and feasibility of private insurance for excess deposits.

The Mutual Savings Central Fund, Inc. was created at the same time as the Cooperative Central Bank and has a similar history. We have been in the business of insuring deposits at State-chartered savings banks for over 50 years and, as with Mr. Burns' fund, we never had a closing that inconvenienced depositors and no depositor has ever lost any money.

URGED TO SEEK FEDERAL INSURANCE

As a result of Ohio and Maryland, we have urged our banks to seek Federal insurance and every one of the banks that was not federally insured has applied for Federal insurance on a voluntary basis.

The first part of my testimony will address briefly the public policy reasons for Federal encouragement of excess deposit coverage. After that, I will address the feasibility of excess deposit insurance and what might be done to make it a more feasible operation.

The first public policy reason is an obvious one—if you have full deposit coverage, you have more stability in the banking system. If a corporation is not worried about losing its funds, it has no reason to start a run on the bank.

Second, there is a perception, and I believe a true one, that there are some banks in the country that are too large to fail. Any depositor that is concerned about placing money in banks at above the $100,000 limit provided by Federal insurance is inclined to place his money in the larger banks on the assumption that he's not going to take any losses. Therefore, if there's private insurance offered for excess deposits, it tends to offset some of the reasonable bias that depositors would have in placing their money in large banks. That would tend to slow any concentration of banking assets and I think that in general is good public policy.

The obverse of that is that it would improve the ability of regional and community banks to compete with those banks that are per-

ceived as too big to fail and I think that is also good public policy, especially considering the fact that there are no inherent economies in those larger banks but only the perception, based upon Government policy or maybe imposed by reality, that those banks in fact must be kept afloat.

Finally, I think that properly structured, you can actually reduce the risk-taking propensity of bankers with excess deposit coverage. By properly structured, I mean that those organizations that do insurance of excess deposits should have the right to charge variable rate premiums and the right to cancel insurance.

Cancellation of insurance is probably in today's environment infeasible for a primary depositor insurer because it guarantees the demise of the bank. But it is not infeasible for excess deposit insurance. In most cases, cancellation of excess insurance would not result in a liquidity crisis but would result in a competitive disadvantage to such a bank, and the prospect of being competitively disadvantaged would make bankers much less prone to take excessive risks.

There are some feasibility problems involved in providing excess insurance. One is that it may be impossible for a private insurer to offer the insurance at a reasonable cost if the private insurer has to duplicate the monitoring system which is now in place by both Federal and State regulators. There has to be some access provided to private insurers to that monitoring system if we're going to have a feasible system of excess deposit coverage.

Second, there's going to have to be cooperation between the private insurer and the supervisory and insuring authorities. For example, the deposit insuring authority has to know in the event of a failure of a bank what kind of losses generally it's going to have to incur. As an illustration, the FDIC's experimentation with so-called modified payouts raises the question of what will happen to the private insurer when deposits in excess of $100,000 are subject to a modified payout and the private insurer insures that excess. Will the excess insurer be treated in the same way that the private depositor is treated in such cases—that is, with an upfront payment based on the FDIC's estimate of what the proceeds from the liquidated estate would be? Or would the excess insurer be treated differently; for example, it might be treated the same way the FDIC treats itself where it simply has to wait for the proceeds of the liquidation to flow.

In any event, there has to be close cooperation between the Federal insurer who provides the primary insurance and the excess deposit insurer.

Third, a primary insurer has to protect against the two traditional insurance problems, moral hazard and adverse selection. Moral hazard is the tendency of risk-taking behavior to be altered by the existence of insurance; I have said before I think that the two safeguards against moral hazard are risk-based premiums and the cancellation of insurance.

Adverse selection refers to the fact that generally the poorer risks will desire insurance while the better risks will feel they don't need it. Two patterns are possible in the area of private insurance. One pattern is that you have a group of institutions which must be members of the insurance entity, such as exists in Massa-

chusetts for both the Cooperative Central Bank and Mutual Savings Central Fund; the other is a voluntary arrangement of the kind that the fund run by Mr. Beason in North Carolina operated under.

I think both of those patterns can work and have the same good public policy impact. In the case of the mandatory situation, you have the advantage that the good risks must be members. In the case of the voluntary, it means that you must be able to reject the bad risks. With risk-based premiums, I think you can have the same public policy impact with either kind of arrangement.

INSURER MUST BE CREDIBLE

Finally, the insurer has to be credible. That means it has to have the financial and mangerial capacity to meet its responsibilities. The recommendations I would make flow very directly out of these considerations and I will summarize them very quickly.

First, a private insurer has to have a tie to the existing State and Federal monitoring systems so that its costs will be reasonable.

Second, a private insurer has to have the close cooperation of the regulatory authorities and primary insurers so that agreements can be reached which will give the private insurer some sense of what its future costs will be.

Third, the private insurer has to have risk-based premiums and the right to cancel insurance under appropriate circumstances.

And finally, the private insurer should be under appropriate regulatory surveillance to make sure that it is a credible insurer both as to its financial capacity and as to its management capacity.

Now some of these proposals may sound radical in the sense that I'm proposing a private-public partnership that may have some novel aspects to it, but in fact what I'm describing is what has existed in Massachusetts for 50 years. The Mutual Savings Central Fund, though it is a mutual organization and all savings banks must be members, still is a private organization. Yet we have the cooperation of and a close working relationship with the banking commissioner and the banking division. We have access to the monitoring systems of the banking division and we get the examination reports by statute. By regulations approved by the commissioner the banks report their financial information to us. We have input into the commissioner's judgments on banks and on his decisions as to whether to close banks or put them under administrative action; the decision to do so is his alone, but there is close consultation.

So I think it has proved workable in Massachusetts and we are looking forward to being a private excess deposit insurer, probably beginning by the end of the summer when we expect that the 96 banks that we insure that were not members of the Federal Deposit Insurance Corporation will be members of the corporation.

Mr. Chairman, you raised a question about whether deregulation has increased the risks to deposit insurance funds and what Congress should do in light of the fact that the activities of some banks are thought to threaten the viability of the funds. If I may, I would like to make some comments on that question.

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First, I think that there's a perception that deregulation has made the banking system less safe than in the past and I would argue that that isn't true. The only protection that one has in holding financial assets is diversification and to the extent that we've had deregulation and diversification I would assert that, in general, the banking system is more safe than it was in the past and not less safe.

Second, there's also a perception that if you allow bankers and State regulators the authority to determine what banks may do, the bankers and regulators will do something stupid that will cause the banks to fail. That strikes me as not being realistic. Bankers don't go out to make lousy loans and State regulators don't try to cause banks to fail. It tends to be embarrassing.

Third, there is an assumption that Federal regulators and the Congress know better than anyone else what kinds of activities are threatening to banks. I would submit that the activities of Federal regulators and the Congress in committing savings and loan associations in this country to making fixed-rate mortgages with short-term funds is the primary factor that has led to the problems in the savings and loan industry that we're struggling with now.

Wisdom doesn't have any particular locus. I don't think that one can determine what activities are best for banks and I think to the extent that you centralize that activity you probably run the risk of somebody making an enormous mistake.

I also believe that if you take a look at the banks that are now in trouble because they have taken advantage of activities granted to them by their chartering authority, you may find that a lot of them are banks whose net worths are in fact below zero. In that kind of a circumstance, there is no disadvantage to a banker who is technically insolvent to doubling his bets and taking chances. If those banks had been closed before their net worth got to zero, this incentive to risk-taking would be eliminated.

So I think you have to sort out as to whether bankers in general are doing things that are risky or whether the risks that we're now incurring arise because we have banks who have no incentive not to be risky because they're playing with the insurance money of the Federal agency.

[The complete prepared statement follows:]

TESTIMONY OF LEONARD LAPIDUS, EXECUTIVE VICE PRESIDENT, MUTUAL SAVINGS CENTRAL FUND, INC.

My name is Leonard Lapidus. I am the Executive Vice President of the Mutual Savings Central Fund, Inc., an organization created by the Commonwealth of Massachusetts which has been insuring deposits in savings banks in the state since 1934. My testimony addresses private insurance of excess deposits -- that is, insurance of deposits in excess of the $100,000 per depositor provided by the FDIC and FSLIC. To our knowledge, the Central Fund and its sister organization, the Cooperative Central Bank, which insures cooperative banks are currently the only "excess deposit" insurers for banks in the United States.

The Central Fund's role as an insurer of excess deposits has evolved over its 50-year history. When our deposit insurance fund was established in 1934, it insured the full amount of all deposits in the state's savings banks. It was not until 1956 that Massachusetts savings banks were permitted to join the FDIC. However, full deposit insurance continued to be a requirement, and those banks that opted for membership in the FDIC continued to have Central Fund deposit insurance for the amounts of any deposits in excess of FDIC limits. At the end of 1984, the Central Fund was still the primary deposit insurer for two-thirds of the state's savings banks and insured only the excess deposits in the other third which had joined the FDIC. However, as a result of the developments in Ohio and Maryland, all Massachusetts savings banks have applied for FDIC insurance, and by the end of the summer, the Central Fund will be insuring only excess deposits. Full deposit insurance for state savings banks continues to be a requirement under Massachusetts law, and continues to have the support of the industry.

I might add that in the over 50 years the Central Fund acted as a primary insurer of deposits of savings banks in the Commonwealth, no depositor ever lost a dime and no depositor was ever denied banking services for even a day. The decisions of our banks to seek federal insurance, which the Central Fund actively encouraged, were voluntary and market driven. The concerns of depositors with large balances were perceived as having competitive consequences. We experienced no runs and no perceptible silent erosion of deposits at our banks.

The first part of my testimony will address the public policy reasons for federal encouragement of private excess insurance systems. After that, I will discuss the feasibility of private excess insurance, and my testimony concludes with some recommendations.

PUBLIC POLICY BENEFITS OF EXCESS DEPOSIT INSURANCE

There are good public policy reasons for federal encouragment of excess deposit insurance. First, and most important, excess deposit insurance contributes to financial stability. The reason is obvious: with a credible system of full deposit insurance, bank runs are eliminated because people have no reason to withdraw their deposits.

Second, excess deposit insurance would help in slowing the trend toward concentration of banking assets. As every observer of the banking scene is aware, for some time there has been a perception that some banks are too big to fail. The FDIC's handling of Continental Illinois served to strengthen this perception, especially after the FDIC had experimented in several smaller bank failures with so-called modified payouts, a variation of the "purchase and assumption" procedures that imposes some losses on uninsured depositors and other creditors. The lesson of Continental Illinois is that large depositors seek out large banks. The money center bank may be no sounder than a smaller bank, but if the depositor knows that the FDIC will not allow a big bank to fail, he will tend to opt for the money center bank. Such considerations militate toward an increase in the concentration of banking assets in the U.S. This increase in concentration is likely to be buttressed by bank mergers based not on economic efficiencies, but simply on the desire of smaller banks to become "too big to fail." That desire will be facilitated in the future by interstate banking. A credible system of excess insurance would help limit the benefits of being too big to fail and therefore, help to counter the tendency toward increasing concentration in banking encouraged by those benefits.

A third public policy benefit that a system of excess deposit insurance can provide is an increase in the ability of the regional and community banks to compete with giant money center banks, strengthening local banking. Being too-big-to-fail gives giant money center banks a competitive advantage over smaller banks. This is not due to any real economies of scale or operating advantages of the large banks, but is simply a reflection of governmental policy that gives them an advantage in attracting large deposits. Full deposit insurance, to the extent it is credible, helps eliminate the non-economic competitive advantage of size and enables regional and community banks to compete more fairly with larger banks.

Another important public policy benefit that may flow from a system of excess deposit insurance is that, if appropriately structured, such insurance can be an effective deterrent to excessive risk-taking by banks. This runs counter to a frequently-voiced criticism of full insurance that it increases risk-taking because the insured large depositor will not exercise discipline over a bank whose activities threaten its financial condition. While there may be some merit to this view under certain circumstances, a system of full deposit

insurance can be structured to deter excessive risk-taking. First, excessive risk taking can be deterred by risk-based premiums. The tendency of full insurance to lead to a more risk-prone behavior can be constrained if such behavior leads to an increase in insurance premiums. In this respect, risk-related premiums need not be "accurate" in an actuarial sense in order to play this useful role, but simply different enough for banks posing different degrees of risk to discourage excessive risk-taking behavior.

Second, risk-taking can also be deterred by the threat of termination of insurance. This can be a very powerful deterrent, especially when coupled with notice to depositors. The depositors who have the largest impact on the behavior of banks are large depositors, and they are likely to be extremely sensitive to any threatened action to terminate insurance. While termination of primary deposit insurance may be infeasible, termination of excess insurance would not, in most cases, cause the runs that jeopardize the health of a bank; termination of excess deposit insurance coverage may cause the run-off of CDs over time as they mature, but termination is unlikely to provoke a liquidity crisis. Thus, because it is not destabilizing, threat of terminating excess insurance is more credible than a similar threat by the FDIC of removal of primary insurance coverage. It would have a direct impact on a bank's ability to compete for large deposits, and thereby, powerfully induce a bank to retreat from risk-exposed activities.

One final potential advantage of excess deposit insurance is that it can act as a check on certain regulatory policies that increase risk taking propensities of bankers and that potentially contribute to the losses to the federal deposit insurance funds. For example, over the years, the FDIC has generally protected itself against loss by closing institutions before they impose large losses on the system. This contrasts with the position of the FSLIC. Many savings and loans have been allowed, as a matter of public policy, to continue to operate even though they are economically insolvent. Institutions in this condition have strong incentives to take great risks in the hopes of returning to solvency -- they are, in effect, playing with the federal insurer's money.

The existence of a private excess deposit insurer might have had some impact on FSLIC's actions with respect to insolvent banks. Since a private insurer can cut its losses to almost nothing if it refuses to insure or terminates the insurance of a bank when it determines the bank has reached zero net worth, given FSLIC's policies a private insurer would probably have been unwilling to insure FSLIC banks. The competitive impact on these banks might have caused FSLIC to operate differently with respect to failing banks.

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FEASIBILITY

The preceding portion of my testimony dealt with the public policy benefits that excess deposit insurance provides. There clearly are good public policy reasons for encouraging the provision of excess deposit insurance, but is it feasible? I believe that it can be, but in order to be successful, any system of excess insurance will require the cooperation of the supervisory authorities and the federal deposit insurance organizations. It also is essential that excess insurers have the authorities necessary to limit their insurance risk. The next part of my testimony addresses some of the issues that bear on the feasiblity of excess deposit insurance.

1. Costs

Using the rate on U.S. Treasury securities as a guideline in estimating the cost of a fully insured CD, a reasonable estimate of the maximum value of excess deposit insurance coverage to medium-sized sound institutions is 20-25 basis points. If excess coverage is to be offered on an economically sound basis, it must be done with costs less than that. (How much less will depend on the value of excess deposit insurance to the bank; that would be the difference between the rate it must pay to attract uninsured CDs and the rate at which it could attract full insured deposits.)

The primary costs of excess deposit insurance are monitoring costs and losses. Monitoring costs are the key because they are closely related to losses -- if monitoring is perfect and the insurer has appropriate powers to deal with insolvency, losses will be minimized. If an insurer has accurate information on the condition of a failing bank, and the bank is closed before its net worth drops much below zero, the loss to the insurer is small.

The experience of the FDIC bears out the importance of accurate monitoring. FDIC losses have been greatest in cases of fraud, where the FDIC did not have good information on the condition of the bank. Examples of this include Penn Square and the Butcher banks in Tennessee. On the other hand, the largest bank failure in history, Franklin National Bank, represented a zero loss to the FDIC because its condition was accurately appraised, and it was sold before its net worth became significantly negative. Most bank failures do not occur as a result of a sudden event, but rather take place over time as net worth declines to zero.

Monitoring banks is very expensive. It is unlikely that a private insurer could establish the type of monitoring system necessary to keep its losses low enough to operate with premiums as low as necessary to be economically feasible. But these costs have already been incurred, and the large - scale monitoring system already exists within the state and federal supervisory agencies. In this respect, the Central Fund is fortunate; it has enjoyed a close working relationship with the

Massachusetts Banking Division. By law it receives examination reports and by regulations approved by the Commissioner collects a broad range of relevant financial information from its members. This legal and historical relationship with the state supervisory system has enabled it to develop an effective monitoring system and to keep its monitoring costs reasonable. This is a critical factor in our ability to provide excess insurance. For private excess insurance to be economically viable, it must be able to tie into the existing supervisory system at reasonable cost.

2. Cooperation of supervisory authorities in dealing with insolvencies.

Related to monitoring of banks is the issue of what the insurer does when it finds a problem. The crucial means of controlling losses to deposit insurer is the ability to close a bank when its net worth is depleted. But banks are chartered to serve public policy objectives, and a private deposit insurer is not likely to be given the power to close a bank. The ability of an excess insurer to participate with state and federal supervisory authorities in finding a solution to the problems of a failing banks would contribute to the feasiblity of excess deposit insurance coverage.

The FDIC, for example, is normally extended these courtesies by state and national chartering authorities. The FDIC itself does not have the power to close a failing bank; it depends upon its relationship with the authorities who do have such authorities -- the Comptroller of the Currency for national banks, and state banking commissioners for state-chartered banks. Again, the Central Fund enjoys a similar relationship with the Massachusetts Banking Division.

Of course, the federal and state chartering authorities may not wish to allow the participation of private insurers in what they perceive to be highly confidential considerations of foundering banks. If it is determined that there are convincing public policy reasons for that position, private insurers could be protected by a legislative prescription and a firm regulatory policy that insolvent banks may not continue to operate.

3. Cooperation of federal deposit insurers

Private excess deposit insurance also requires the cooperation of, and a close working relationship with, the FDIC and FSLIC. It is essential that agreements be reached with the federal insurers that delineate exactly what the excess insurer's responsibilities will be in the event of a bank failure, whether there is a payout, a merger, or a purchase and assumption. It is also essential to know about, and have some input into, changes in liquidation and assistance policies.

The reasons are obvious -- FDIC and FSLIC have the power, in effect, to impose losses on an excess insurer by their liquidation and assistance policies. For example, to date no large bank failure has resulted in a payoff of uninsured depositors; instead the uninsured deposits have been assumed by another bank, and no losses have been suffered. If that policy continues, an excess insurer would suffer no losses by insuring deposits in such banks. However, the FDIC's experimentation with modified payouts, under which only insured deposits are assumed by another bank while certain losses are charged against excess deposits, would have a major impact on the costs of excess insurers. Therefore, it is essential that excess insurers have reasonable input into such matters in order to protect themselves against revisions in policies that would impose unbearable losses, and it is also necessary that excess insurers be able to rely on the reasonable continuity of federal insurers' policies that may have cost impacts so that pricing of insurance during the contract period would not prove to be woefully inadequate. Rapid changes in the policies of federal insurers in this regard and the attendant uncertainty of the costs that excess insurers might incur would lead to higher premiums and shorter contracts that might make the private provision of such deposit insurance infeasible.

4. Authority to control risk exposure.

If excess deposit insurance is to be feasible, the deposit insurer must have the ability to deal with the traditional insurance problems of "moral hazard" and "adverse selection." Moral hazard refers to the tendency of behavior to be altered by the existence of insurance. The existence of full deposit insurance may encourage excessive risk-taking behavior because the ability of the bank to attract deposits will be unaffected by its financial condition. This issue of moral hazard was dealt with earlier in my testimony. The best means of discouraging increased risk-taking is through a system of risk-based premiums coupled with an ability to terminate insurance as a last resort.

Adverse selection refers to the fact that when insurance coverage is available and optional, the poorer risks will desire insurance while the best risks will not want to pay for insurance that they may not need. Adverse selection can be handled by making full deposit insurance mandatory, as is the case in Massachusetts. Another approach is for the insurance to be optional and allow the insurer to reject unqualified applicants. Both approaches have problems. The optional system only prevents bad risks from participating, but doesn't assure that the good risks will participate, a situation which limits risk-spreading and may not be desirable when there is a public interest to be served by universal coverage, as may be the case with deposit insurance. The mandatory approach leaves no flexibility for dealing with banks whose actions pose unacceptable risks to the insurance fund. The Central Fund

favors the mandatory approach coupled with ability to terminate insurance with appropriate due process protections when a bank's risk-taking behavior cannot be controlled and poses a risk to the fund.

5. Credibility of the insurer.

An essential requirement for an excess deposit insurance system to be successful is credibility. Credibility is more than financial capacity of a fund in some actuarial sense. It includes an element of public confidence that can be retained even under periods of financial stress. The federal systems have that, not just because of the size of the funds, but because of the underlying belief that if the funds prove inadequate, the U.S. government will back up the insurance system. An insurance system backed by the full-faith-and-credit of a state would probably also have such credibility, though there are no such systems now.

Credibility may require that the market be convinced that a single disaster cannot bring down the system as Home State did in Ohio. This may require a limit on coverage, or a limit on bank's ratio of non-federally insured to total deposits, or the reinsurance of such risks (though no such reinsurance market now exists). Without credibility, a system of excess insurance provides no benefits to depositors, banks, or the financial system generally.

RECOMMENDATIONS

The last section of my testimony consists of recommendations for making private deposit insurance feasible.

For excess deposit insurance provided by private firms or mutual companies, such as the Central Fund, to be viable and successful, the most important element is that costs of providing the insurance be economic. The most substantial obstacle to that end is the costs of monitoring. It is recommended, therefore, that the federal insurers and the federal and state chartering agencies make available to private insurers, at reasonable cost, the examination reports and financial reports which they receive in their legal capacities as bank regulators. In some cases, state and federal law would have to be amended to allow regulatory agencies to provide such information to private insurers; in other cases the authorities to do so already exist. Alternatively, law and regulations that require extensive disclosure of information about banks might be a reasonable effective substitute, though not as good as access to information available to, and analyzed by, regulators. In the abscence of these two approaches, an excess deposit insurer would have to gain such information by contract with the insured, but this approach is much inferior, and the costs of collecting and processing the information might prove to be too great to make the service economic.

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The second recommendation is that state and federal regulatory authorities and federal insurers regularly consult with private excess deposit insurers and enter into arrangements settling the financial responsibilities of such private insurers in cases of bank failures under the various forms of resolution of such failures. It would be helpful if state and federal chartering authorities were committed by law and pledged by policy to require an insolvent bank to be closed.

The third recommendation is that private excess deposit insurers be granted the authority to charge risk-based premiums and terminate insurance. Most licensed insurance companies will not need special authority in this regard; those deposit insurers, such as the Central Fund, that are creatures of their legislatures may need the grant of such authority by statute.

The fourth recommendation relates to the credibility of the private excess deposit insurer. If such a company is to be given special access to the resources of state and federal regulatory agencies, it should be subject to reasonable regulation and supervision. To be avoided at all costs is the failure of a private deposit insurer. The appropriate regulatory agency should be given authority to set certain minimum financial standards and to examine the private insurer for compliance with such standards.

These proposals may present what some people might think of as a novel departure in the relations between public agencies and private entitites in the area of bank regulation. However, most of the features I have discussed have existed in Massachusetts for over 50 years and have worked well. An appropriate relationship between public agencies and private entities can be shaped that will contribute to the public well-being in the form of a safer and more responsive banking system.

The CHAIRMAN. Thank you, sir.
Mr. Artemenko.

STATEMENT OF GENE ARTEMENKO, PRESIDENT, UNITED AIRLINES EMPLOYEES CREDIT UNION, CHICAGO, IL

Mr. ARTEMENKO. Senator Garn, I am pleased to appear before you this morning to testify regarding the role of private deposit insurance as it relates to credit unions in general and to the United Airlines Employees Credit Union in particular. I am especially pleased that the committee has seen fit to have one of the institutions testify.

ASSETS OF APPROXIMATELY $860 MILLION

Our credit union has 76,000 members and our current assets are approximately $860 million. We are the second largest State-chartered credit union in the country and we are the largest privately insured credit union.

Our philosophy is very simple. We offer a traditional savings account and consumer loans. We do not offer share drafts or checking accounts, no certificates of deposit, travelers checks, money orders, money market accounts, charge cards, or mortgages. We do not dispense cash and we do not accept it.

The rate of return on our loan portfolio is 12.6 percent and 60 percent of the loans are out at 12 percent. The dividend we've paid for the last two quarters has been 10.5 percent.

Our membership is only open to employees of the company and does not include spouse or family membership, and membership ceases in the credit union when the employee leaves the company.

Today, 95 percent of United Airlines employees belong to the credit union. Our credit union will celebrate its 50th anniversary this year and I have been employed by them for the last 28 years. For the first 45 years of the existence of our credit union we did not have depositors insurance. In 1971, the National Credit Union Administration Insurance Fund became available. At that time our board of directors reviewed that and because of the conservative policies of our credit union and the strong liquidity position they chose not to purchase the insurance at that time but to return the premium we would have paid back to the membership in the form of dividends.

In 1981, the State of Illinois required State-chartered credit unions to obtain deposit insurance. Fortunately, the State legislature gave us the choice of Federal insurance or the National Deposit Guaranty Corp., which is a private insurer. We chose the private insurer because we wanted to continue to be regulated by the State and not take on the additional burden of Federal regulation.

The experience of our credit union has proved that there's a role for private insurance that has enabled us to continue to operate in Illinois where we believe the statutory and regulatory climate is as good or better than any other State. Certainly, private credit union share insurance can and should be facilitated.

Step 1 would be to recognize the positive role private deposit insurance has played in the credit union movement.

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Step 2 would be to free Federal credit unions to choose between Federal and private deposit insurance. Let the market decide the merits of private insurance.

Among those credit unions currently free to choose between Federal and private insurance, approximately 50 percent have chosen the private deposit insurance and if Federal credit unions were free to choose their insurer, both insurance systems would benefit.

Thank you.

[The complete prepared statement follows:]

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Testimony of Gene Artemenko, President, United Air Lines Employees' Credit Union

Senator Garn and members of the Banking, Finance and Urban Affairs Committee:

I am pleased to appear before you this morning to testify regarding the role of private deposit insurance as it relates to credit unions in general and to United Air Lines Employees' Credit Union in particular.

United Air Lines Employees' Credit Union

Our Credit Union was founded on October 26, 1935 by 9 employees of United Airlines. Today it has grown to 76,000 members and $859 million in total assets. We are the second largest state chartered credit union in the nation and the largest privately insured credit union. It was founded as an employee benefit and functions in that manner today. We refer to the Credit Union as a plain vanilla Credit Union. In other words, we don't offer the myriad of services available at banks, savings & loans and other credit unions in the U.S. We do not offer share drafts or checking accounts, certificates of deposit, traveler's checks, money orders, charge cards, money market deposit accounts or mortgages. In fact, we do not dispense cash nor do we accept it. Disbursements are made by check and receipts are through payroll deduction and checks or money orders.

Our Credit Union philosophy is a very simple one. We encourage employee thrift by providing a convenient place to save with a fair rate of return and use those funds to make loans to employees for provident and productive purposes. Because we have kept the operation of the Credit Union simple, we are able to operate with only 60 employees. This basic operating philosophy allows us to maintain an expense ratio of less than 5% and at the same time current lending rates average 12.6% and dividends currently paid average 10.50%.

Our membership is open only to the employees of United Airlines and does not include spouse or family membership and membership ceases when the employee leaves the Company. Today 95% of United Airlines' employees belong to the Credit Union.

Deposit Insurance

Our Credit Union will celebrate its 50th anniversary on October 26 of this year. For

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the first 45 years of the Credit Union's existence, it did not have deposit insurance. In 1971 this insurance became available to credit unions from the National Credit Union Administration Share Insurance Fund (federal insurance). Since the Credit Union's strong cash position and conservative policies did not warrant deposit insurance, the Board of Directors elected not to obtain it. Funds that would have been used to purchase this insurance were instead returned to members in the form of dividends.

Banks and savings & loans were required to obtain deposit insurance many years earlier because of the myriad of investments available to them, i.e., land, buildings and common stock. By comparison, credit unions could only invest members' funds in loans to other members, obligations of State and U.S. Government Agencies and certificates of deposit or passbook type accounts at banks and savings & loans.

In 1981 the State of Illinois required that state chartered credit unions obtain deposit insurance from either the National Credit Union Administration Share Insurance Fund or the National Deposit Guaranty Corporation (private insurance). Both insurers were approved by the Illinois Department of Insurance and the Governor after being examined by the Department of Financial Institutions. The Board of our Credit Union carefully reviewed the programs offered by both the National Credit Union Administration (NCUA) and the National Deposit Guaranty Corporation (NDGC). Their review concentrated on three issues: coverage limits, cost of coverage and regulatory effect insurers could have on Credit Union operations. Based on the results of their review, the Board selected NDGC to provide deposit insurance. NDGC provides dollar-for-dollar unlimited coverage on all savings (regular and IRA). A projection of costs, which included premiums, reserve requirements and additional assessments, showed NDGC to be the most economical.

By selecting the private insurer, the Board supported a dual chartering system and precluded our state chartered Credit Union from being regulated by a federal agency that would impose additional federal regulations on our operations.

Each credit union approved for membership in NDGC must meet and maintain high standards in management practices and operating policies. NDGC requires all of its member credit unions to submit financial reports on a monthly basis. Regular reviews are also

conducted by the appropriate government agency charged with the responsibility of supervising the member credit unions.

Founded in 1973, National Deposit Guaranty Corporation insures only credit unions and currently provides deposit insurance to 493 credit unions located in 22 states. In addition to a capitalization fund of 1% of shares insured, NDGC also has a $12 million line of reinsurance and a $100 million line of credit through a consortium of banks.

The President of NDGC is the former Superintendent of Credit Unions for the State of Ohio. Among those serving on the Board of Directors is the immediate past Attorney General for the State of Ohio and the former Chief Justice of the Ohio State Supreme Court.

Recommendation

The experience of our Credit Union is proof that there is a role for private insurance. It has enabled us to continue to operate in Illinois where we believe the statutory and regulatory climate is as good as or better than any other state. Certainly private credit union share insurance can and should be facilitated. Step one would be to recognize the positive role private deposit insurance has played in the credit union movement. Step two would be to free federal credit unions to choose between federal and private deposit insurance. Let the market decide the merits of private insurance. Among those credit unions currently free to choose between federal and private insurance, approximately 50% have chosen private deposit insurance. If federal credit unions were free to choose their insurer, both insurance systems would benefit.

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The CHAIRMAN. Thank you, sir.

As you heard in the previous panel, there were several comments, including mine, that the non-Federal insurers were on their way out. Mr. Beason, you have testified to that fact: that your corporation is on the way out as a result of panics in Ohio and Maryland.

First of all, let me ask you, do you think there is any method through reinsurance or pooled liquidity funds whereby primary deposit insurance could still be feasible?

Mr. BEASON. It's possible. I'm not sure what that structure would be at this time. I do think the credit union industry is totally different than the S&L or banking industry. It's perceived to be different by the people who do business with them and I think private deposit insurance as primary insurance for credit unions is a viable option to not only allow them to stay in existence but to encourage.

STANDARDS FOR PRIVATE INSURERS

I do think there should be some national standards for deposit insurers, including those that insure credit unions. As I indicate in my written testimony, the National Association of Credit Union regulators is attempting on its own to develop such standards and they are to be complimented for doing that.

The problems with Ohio and Maryland were problems of bad management by the board of directors of those private insurers and it's possible there are others out there like that. If there are, they should not be allowed to continue in business. But those that are properly operated should not only be allowed but encouraged to exist.

The CHAIRMAN. Mr. Burns, some critics have suggested that the reason that the non-Federal system is not working is the lack of interaction and cooperation between private insurers. Do you think it's possible that a new system could be developed for primary coverage based on a network of insurance funds?

Mr. BURNS. No, sir; I do not.

The CHAIRMAN. Do any of the others of you have a comment on that?

Mr. ARTEMENKO. Well, I don't know that a network is necessary. The National Deposit Guaranty Corporation insures 493 credit unions in 22 different States and we haven't had a problem with it. With our 76,000 depositors, we have better than 3,000 members in both Ohio and Maryland and, sure, we got questions about the private insurance and we explained to them just exactly how it operates and they weren't—they just wanted to be reassured that we were confident in the insurance that we carried and we can't identify 1 person out of those 76,000 members that withdrew any funds because of the problem that occurred in Maryland and in Ohio. Those were savings and loan problems. They weren't private insurance problems. And in the month of June, our shares increased by over $50 million, and that's with a strike for half the month.

So the private insurance can't be a problem. At least in our credit union and from what I can discern, I don't know of a single credit union that has a large amount of people that have taken money out because of the problems with private insurance.

The CHAIRMAN. Well, you're correct, it was an S&L problem, but the S&L problem caused the insurance funds problems because of the lack of confidence and the people waiting in line at those institutions. So you can't totally separate the S&L problem from the insurance problem in those States. It became a problem for the insurers because of the lack of confidence in the S&L's. I understand you're talking about a different situation with your membership.

Mr. ARTEMENKO. But I think all credit union membership—I think ours, because of the age of the credit union and the probably close common bond we might have some advantages, but I think generally—the credit unions are a different animal. I would suggest possibly that in North Carolina I don't think credit unions were the problem for their fund.

The CHAIRMAN. Well, I agree that credit unions are a different animal and I wouldn't expect you to be testifying on behalf of anybody else but credit unions.

Mr. Beason, did you have a comment?

Mr. BEASON. We did have some problems with public confidence in the credit unions in North Carolina. One of the reasons that we decided to go out of the insurance business for not only S&L's but credit unions and industrial banks, was that we found public concern regarding all those institutions.

I think there is a correlation between public confidence in private insurance and in the S&L's, or credit unions, or whatever type of institution. I think it's pertinent to point out that in Ohio, when the Governor closed privately insured thrift institutions, there were also a small number of totally uninsured savings and loans in the State of Ohio. None of them were affected. None of them were closed. None of them experienced runs. And our research—and we put two or three people in the field in Ohio for a number of days—indicated a large number of telephone calls from customers to those uninsured savings and loans. The question was: Are you insured by the Ohio Deposit Guaranty Fund? Their answer was, "We don't have insurance from anybody." And nobody withdrew their money.

ROLE STILL FOR PRIVATE INSURERS

So I think the lack of public confidence in Ohio was because of the name, or the term, or the concept of private insurance and we did experience some of that in North Carolina with S&L's, credit unions, and industrial banks.

The CHAIRMAN. Well, all of you seem to believe from your testimony that there is still a role for non-Federal deposit insurance, at least in coinsurance and excess insurance.

Mr. Lapidus, is there value to large institutions—you talked about those that would not be allowed to fail—or is excess insurance only valuable to small institutions?

Mr. LAPIDUS. I think that there has not been a solution to the too-big-to-fail problem. There is an inequity between large institutions and small institutions, if that in fact exists and I think as a matter of fact it does exist. I think it would be very difficult for an excess insurer to insure a giant institution. I don't think there's

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enough capital available to commit to insure large institutions that have excess deposits on the order of 25, 35, 50, 70 percent.

You might be able to induce a private insurer to take those institutions if its loss was limited in some way. So there might be something worked out for private insurers to work in that area. The difficulty is, if the coverage isn't large enough and the institution comes under a cloud, you are not going to stop the run. You have an inherent conflict between the stability issue and the insurance issue, but that exists right now and I haven't heard anybody describe any reform that is going to solve that problem very easily.

The CHAIRMAN. Why do you say there's a difference between the big and the small institutions?

Mr. LAPIDUS. Excuse me?

The CHAIRMAN. In terms of whether they're going to be saved or not. I hear that all the time, not just from you, but I hear it all the time primarily as a result of Continental Illinois. Do you have any evidence that that is the case?

Mr. LAPIDUS. I don't know if anybody can specify what is large—what is too big to fail. I think that depositors make that determination. They make guesses at it and essentially will be playing a poker game with the Federal insurers.

The CHAIRMAN. Well, the reason I asked that question is because if you look back at the failed institutions over the last few years you will find that, big or small, almost all of them have been handled by assisted mergers. They have not been allowed to fail, and yet I hear this constant plea that, "well, if you're Continental you get saved; but if you're a little guy you don't." Well, most of the little guys were saved by assisted mergers as well and were not allowed to fail nor were the depositors over $100,000 allowed to lose their money. There are a few where the FDIC and the FSLIC just went in and paid out the depositors, but most of them were handled like Continental, not in specifics but in general.

Mr. LAPIDUS. Oh, yes, that's absolutely accurate. But I think that there's been new stress on so-called market discipline so the FDIC has been experimenting with a change in that policy by doing modified payouts. They've done modified payouts in small institutions but when faced with Continental they didn't do it, and I think that that was a message.

I don't see the feasibility of doing a modified payout for an institution the size of Continental and I don't think the FDIC——

The CHAIRMAN. Isn't it also true—I get some of the complaints and when they started to think it through they withdraw their complaint—that there's a possibility of dozens of small institutions failing as a result of Continental's failure. So you weren't just saving Continental. In the case of Penn Square, as you well know, there were a lot of credit unions involved with Penn Square. So when you're dealing with the so-called—all I'm trying to do is point out once again for the record when I hear these cute little cliches—not from you gentlemen but from a lot of people—"if you're big you get saved and if you're small you don't and it's all unfair." They're not thinking the problem through or looking at the record of what has happened to these failed institutions. They also don't look at all of the little guys who were involved with the big guy who would go down with him if you just simply say, well, fine, let

the biggy go. There are estimates of more than 100 potential failures if Continental had gone down.

Mr. LAPIDUS. Please let me clarify. I think that the FDIC's handling of Continental was appropriate. I'm not arguing about that. I think that Continental in fact had to be handled that way. I think they did a very good job. In terms of who got injured in Continental, the appropriate parties got injured—the management was injured, the stockholders were injured. There were some subordinated creditors who probably should have been injured but because of the agreements were not. But I think that's only a footnote to what was a pretty good job.

LARGE INSTITUTIONS WILL HAVE TO BE SALVAGED

My point is only that the Continentals will probably have to be saved and in the market for deposits that means that those banks that are perceived to be handled as Continental was are going to have an advantage in gathering deposits.

The CHAIRMAN. Mr. Beason.

Mr. BEASON. I think it's safe to say, Mr. Chairman, that Continental did fail and was allowed to fail.

The CHAIRMAN. Well, yes, you are correct. The stockholders took more than a $1 billion hit. Management was removed and new management was brought in. You are correct. However, people did not perceive it was a failure because, well, we just didn't go in and let it go belly up and pay off the depositors up to $100,000. It was not that kind of a failure, but, yes, Continental did fail. You are absolutely correct. They were allowed to fail.

Mr. BEASON. And to further your comment, if Continental had been closed, I've read that it would have taken down from 40 to 70 smaller banks across the country and I think public policy dictates we shouldn't do that.

I think part of the reason you continue to hear that big banks are not allowed to fail and small ones are is the social impact at the local level when a small bank is closed. I think the FDIC needs to reexamine its policy of those closures and payouts. I think if they move early enough they can force mergers and consolidations and can protect their fund and still keep institutions open. Closing financial institutions, that's what causes this public confidence to just go out the window so fast that we can't deal with it. For a Continental to happen the way it did or a small institution to be merged into another, the public is perfectly willing to accept that and move right on with it.

The CHAIRMAN. Are there any closing comments any of you wish to make?

Mr. BEASON. Thank you for allowing us to be here.

The CHAIRMAN. Thank you very much for coming.

[Response to written questions from James L. Burns, Jr., Donald R. Beason, and Leonard Lapidus follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN

The CO-OPERATIVE CENTRAL BANK
265 FRANKLIN STREET · BOSTON · MASSACHUSETTS 02110
(617) 439-4411

JAMES L. BURNS, JR.
EXECUTIVE VICE PRESIDENT
AND TREASURER

October 17, 1985

Q. 1. Should a federal insurance agency be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed institution with any profit after administrative costs arising from the transaction returned to the original stockholders?

A. 1. DEPOSIT INSURER ACQUISITION OF STOCKHOLDER INTEREST.

I would not recommend that any deposit insurance agency acquire or attempt to acquire such stockholder interest. I would recommend that when early detection indicates that remedial action (merger arrangements, etc.) is necessary to protect depositor interests that the federal and state laws clearly provide that: a) stockholder be subordinate to depositors and deposit insurers, and b) stockholder rights be suspended, frozen or otherwise lost and that any residual values or rights be decided at the sole discretion of the deposit insurer.

Q. 2. If the burden of mismanagement were placed squarely on the managers and stockholders and most failures were handled through a purchase and assumption at an earlier stage - immediately or through a conservatorship - regardless of size - wouldn't this dispose of the fairness question as it relates to large and small institutions? Why couldn't a Continental type solution be applied to failing small banks? If an insurance agency is funded totally by institutions is there a federal subsidy?

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A. 2a. BURDEN OF MISMANAGEMENT/FAIRNESS.

I would agree. I support early stage remedial action.

2b. CONTINENTAL/SMALL BANKS.

This is difficult to answer. Situations would vary and require tailoring on the part of the deposit insurer. I think care should be taken so that all depositors are equally protected in all insured banks. However, a solution for any particular bank should include, but not be limited to, the effect it would have on the local and national economy.

2c. FEDERAL SUBSIDY.

If a portion of the risk could be responsibly shared and laid off to insurance funds which are healthy and well managed and possibly approved by some federal entity, some form of subsidy, i.e. tax exemption, lines of credit at the Federal Reserve, should seriously be considered.

Q. 3. Is there a place for self-regulation in the banking industry that draws on the talent within the industry? If so, how could concepts of self-regulation be included in the federal supervisory system?

A. 3. SELF REGULATION.

Existing corporate structure should provide the necessary and practical self regulation through Board supervision, management controls and internal audit functions. Another theoretical layer or entity will be of little value and will only increase paper, time and expense of non-productive persons. Practical, not theoretical, action is needed. As quoted in my testimony, "Let's not reinvent the wheel, but rather apply the brakes earlier or change the driver." Early detection and a prompt remedial action program with the existing deposit insurance structure is the best and only course that should be pursued.

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Q. 4. Should CPA audits be required of all depository institutions and their holding companies? What steps, if any, should be taken that would permit federal bank examiners to place more reliance on auditors' evaluation of management systems and controls? Would this help examiners focus on asset quality, and bank risk levels, etc.?

A. 4a. CPA AUDITS.

Audit reports and management or internal control letters should be submitted to the deposit insurance agency. We have been privy to bank examination reports as well as audit reports from our member banks for some years now and have found them to be quite useful as part of our monitoring program.

4b. STEPS FOR GREATER RELIANCE BY EXAMINERS.

Supervisory and insurance agency review of audit procedures, audit programs, opinions, footnote disclosures, and management letters on any bank with or under supervisory or deposit insurance action. We might also want to consider the SEC practices and procedures relative to CPA discipline on such review processes. This should help examiners to concentrate on safety and soundness matters.

Q. 5. What is your view of permitting federal regulators to require institutions to pay special assessments for the increased examinations made necessary by their classification as a problem institution?

A. 5. SPECIAL ASSESSMENTS/INCREASED EXAMINATIONS.

I would support cost reimbursement of examinations but not risk based premium assessments. As in my prior testimony, I feel that such a theory suggests risk is allowed to exist at added premium. Higher premium, higher risk will equal higher loss. What value is the interest or premium if principal is lost?

Banking safety is based on public confidence. This public confidence has eroded lately with all of the problems and failures that have occurred in the banking system. Early detection and prompt remedial action with less public disclosure or notice (little fanfare) is the only route to restoration of public confidence and a stronger overall banking and deposit insurance system.

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Q. 6. If regulators are rarely suprised by a bank failure - isn't the answer swifter or more appropriate regulatory action rather than increased market discipline? Wouldn't giving the regulators the ability to close an institution earlier be appropriate? Should a regulator require bank management to file a confidential bank failure plan approved by its board of directors if it falls a certain percentage below its minimum capital level for a specified period of time?

A. 6a. SWIFT ACTION.

I am a firm believer that swift, well-orchestrated action is very effective in answering problem situations.

6b. EARLIER CLOSING AUTHORITY.

We in Massachusetts have always maintained that the closing and/or liquidation of a financial institution is the last alternative and should be avoided at all cost. Regulators and insurers should take all steps to restructure, merge or rehabilitate a troubled institution. The closing of an institution is not only the most costly process but is more damaging to all financial institutions, whether they be well run or not. It flies in the face of the maintenance of public confidence.

6c. BANK FAILURE PLAN.

Regulators, depending on the situation, require bank management to file a management plan which would propose a course(s) of action to substantially alleviate or solve the bank's problem. These should be expeditiously reviewed by the regulator and if found to be impractical the regulator should be the one who determines what action should be taken to solve the problem. After all, management in all probability has been a major cause of the problem.

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Q. 7. With regard to the concern that some states may have expanded banks product authorities beyond what may be prudent, can this issue be dealt with by giving the federal insurance agencies the authority to require a prudent level of capital to support that activity in order to maintain insurance rather than giving any federal agency the authority to override a state legislature? In other words, wouldn't the adoption of risk-based capital standards go a long way toward solving this problem?

A. 7. RISK BASE CAPITAL STANDARDS.

The requirement to maintain "proper levels of capital" has little merit, in my opinion. If state regulations permit a financial institution to act in a manner which the federal insurers consider imprudent, a capital level of 9, 10, or 11% could be dissipated quickly. I do believe, however, that if a financial institution adopted federal insurance, they should be made to adhere to reasonable guidelines established by the insurer.

Respectfully,

James L. Burns, Jr.
Executive Vice President

JLB:t

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FIAC
Financial Institutions Assurance Corporation
Donald R. Beason
President

RESPONSE TO QUESTIONS FROM SENATOR GARN

Question 1. Should a federal insurance agency be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed institution with any profit after administrative costs arising from the transaction returned to the original stockholders?

YES! THE REGULATOR SHOULD HAVE THE AUTHORITY TO TAKE CONTROL OF ANY FINANCIAL INSTITUTION UPON A FINDING THAT IT IS "IN A FAILING CONDITION" OR IN "ABOUT TO BECOME INSOLVENT".

TO WAIT UNTIL AN INSTITUTION IS, IN FACT INSOLVENT IS TO WAIT TOO LONG. THERE IS NO VALUE AT THAT POINT. IF YOUR GOAL IS TO AVOID LOSSES, YOU MUST MOVE WHILE THERE IS VALUE LEFT IN AN INSTITUTION.

Question 2.A. If the burden of mismanagement were placed squarely on the managers and stockholders and most failures were handled through a purchase and assumption at an earlier stage - immediately or through a conservatorship - regardless of size - wouldn't this dispose of the fairness question as it relates to large and small institutions?

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YES! THE GOAL OF THE INSURANCE FUNDS SHOULD BE TO AVOID LOSSES. NO MATTER WHAT THE SIZE.

Question 2.B. Why couldn't a Continental type solution be applied to failing small banks?

IT COULD BE! THIS IS JUST A POLICY MATTER, NOT ONE OF CAN IT BE DONE.

Question 2.C. If an insurance agency is funded totally by institutions, is there a federal subsidy?

THAT IS A BIG IF. THE CONGRESS HAS SAID, IN RESOLUTION, THAT THE FULL FAITH AND CREDIT OF THE UNITED STATES GOVERNMENT IS BEHIND THE FEDERAL DEPOSIT INSURANCE FUNDS.

Question 3. Is there a place for self-regulation in the banking industry that draws on the talent within the industry? If so, how could concepts of self-regulation be included in the federal supervisory system?

YES! THE CONFERENCE OF STATE BANK SUPERVISORS HAS A PROGRAM THAT ASSEMBLES A TEAM OF EXPERTS TO REVIEW THE QUALITY OF STATE BANKING DEPARTMENTS. THAT CONCEPT COULD BE MODIFIED

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TO OPERATE WITHIN THE REGULATORY SYSTEMS AND WITHIN THE INDUSTRIES.

THE QUESTION IS, WHO RATES THE QUALITY OF FEDERAL AND STATE REGULATORS?

COULD THE FEDERAL RESERVE SYSTEM CONDUCT EXAMINATIONS ON THE FDIC, FSLIC, FHLBB AND COMPTROLLER OF THE CURRENCY?

SHOULD THERE BE A MANAGING AGENCY FOR THE FINANCIAL INSTITUTIONS REGULATORS? IF SO, SHOULD IT NOT BE THE FEDERAL RESERVE?

I SUGGEST SERIOUS CONSIDERATION BE GIVEN TO PLACING ALL FINANCIAL REGULATORS, UNDER THE UMBRELLA OF THE FEDERAL RESERVE.

Question 4.A. Should CPA audits be required of all depository institutions and their holding companies?

YES! IT HAS BEEN MY EXPERIENCE THAT THE BIG 8 CPA FIRMS HAVE BETTER TRAINED PERSONNEL AND WITHOUT QUESTION, MORE AND BETTER TECHNOLOGY THAN DO STATE OR FEDERAL EXAMINERS.

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IT IS DIFFICULT TO BELIEVE THIS IS NOT THE CASE NOW.

Question 4.B. What steps, if any, should be taken that would permit federal bank examiners to place more reliance on auditors' evaluation of management systems and controls?

STATE AND FEDERAL REGULATORS SHOULD CONSULT WITH AN INSTITUTION'S INDEPENDENT AUDITORS ON A REGULAR BASIS AND THEY SHOULD SHARE INFORMATION. THE AUDITORS SHOULD HAVE ACCESS TO REGULATORS' EXAMS AND EXAM WORK PAPERS.

Question 4.C. Would this help examiners focus on asset quality, and bank risk levels, etc?

YES! CURRENTLY THERE ARE TOO MANY PEOPLE "LOOKING" AT FINANCIAL INSTITUTIONS WITHOUT ANY COORDINATION. WITH A PROPERLY COORDINATED APPROACH AND WORKING RELATIONSHIPS BETWEEN REGULATORS AND AUDITORS, THE JOB WOULD BE EASIER FOR ALL CONCERNED. NOTE: FEDERAL REGULATORS SHOULD BE WORKING TOGETHER AND SHARING INFORMATION ALSO.

Question 5. What is your view of permitting federal regulators to

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require institutions to pay special assessments for the increased examinations made necessary by their classification as a problem institution?

IT IS VERY SIMPLE. THOSE THAT REQUIRE THE TIME, TALENT AND EFFORT SHOULD PAY THE COST.

IF IT IS NOT BEING REQUIRED NOW, IT SHOULD BE IMPLEMENTED IMMEDIATELY.

Question 6. If regulators are rarely surprised by a bank failure - isn't the answer swifter or more appropriate regulatory action rather than increased market discipline? Wouldn't giving the regulators the ability to close an institution earlier be appropriate? Should a regulator require bank management to file a confidential bank failure plan approved by its board of directors if it falls a certain percentage below its minimum capital level for a specified period of time?

YES. YES. AND YES. THE BOARD OF DIRECTORS OF A FAILING INSTITUTION SHOULD BE REQUIRED TO VOTE ON THE ISSUE OF THEIR CONDITION. IF THE INSTITUTION IS IN A "FAILING CONDITION" THE BOARD OF DIRECTORS SHOULD HAVE A FORMAL VOTE ON THAT MATTER AND REGULATORS SHOULD HAVE THE AUTHORITY TO TAKE "ANY ACTION NECESSARY"

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TO PROTECT THE DEPOSITOR AND THE INSURANCE FUND.

Question 7. With regard to the concern that some states may have expanded banks' product authorities beyond what may be prudent, can this issue be dealt with by giving the federal insurance agencies the authority to require a prudent level of capital to support that activity in order to maintain insurance - rather than giving any federal agency the authority to override a state legislature? In other words, wouldn't the adoption of risk-based capital standards go a long way toward solving this problem?

YES. RISK BASED CAPITAL REQUIREMENTS SHOULD BE IMPLEMENTED NOW! THAT AUTHORITY SHOULD BE DELEGATED TO THE APPROPRIATE REGULATOR AND THEY SHOULD BE GIVEN TIME TO FINE TUNE SUCH A SYSTEM. REGULATORS SHOULD HAVE AUTHORITY TO QUICKLY CHANGE, ADD TO, OR DELETE REGULATIONS ON THIS SUBJECT BECAUSE OF THE RAPID CHANGES THAT TAKES PLACE WITHIN THE FINANCIAL INDUSTRY.

REGARDING ACTIVITIES OF FINANCIAL INSTITUTIONS, THOSE TAKING THE RISK SHOULD SET THE RULES. THE INSURANCE FUND NOW TAKES THE RISK, LET THEM WRITE THE RULES ON SAFETY AND SOUNDNESS.

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THERE IS ONE POINT SELDOM DISCUSSED, AND THAT IS, DOES ANYONE WITH A FINANCIAL INSTITUTION CHARTER HAVE A RIGHT TO A FEDERAL GUARANTEE? THE ANSWER IS NO. THEREFORE, IF A BANK WISHES TO ENGAGE IN UNSAFE AND UNSOUND ACTIVITIES, LET THEM DO SO WITHOUT FEDERAL INSURANCE.

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Mutual Savings Central Fund, Inc.
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Leonard Lapidus
Executive Vice President

1. Should a federal insurance agency be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed institution with any profit after administrative costs arising from the transaction returned to the original stockholders?

There is no question that, in theory, giving a federal deposit insurance agency the authority to take control of a bank and arrange a merger when the bank is at or near economic insolvency would be an effective tool in controlling deposit insurance losses. If the insurer can take control of a bank before its net worth drops below zero, the loss to the insurer will be small even if the bank must be liquidated. Once net worth reaches zero, the bank's management is gambling with the deposit insurer's money, and the incentive is to increase riskier activities where the potential returns are the greatest and hope for the best.

Nevertheless, while the theory is appealing, there are practical impediments that make implementation difficult. First, the point at which a bank is "economically insolvent" cannot easily be determined; it involves a subjective judgment based on many factors, including the book and market values of a bank's assets, cash flow, liquidity structure, and depositor confidence. It is probably fair to say that the point when the market value of a bank's assets equals its liabilities is too early to close the bank — most of the thrifts in the country would have to be closed if that were the standard — but the point when book value of assets equals its liabilities is way too late. Economic insolvency occurs somewhere between these boundaries, but at different points for different banks. A bank with a market value net worth of zero with high quality assets and cash flow to meet its maturing liabilities may be more economically solvent than a bank with positive net worth but a high level of

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risky or substandard assets. There is a great deal of judgment involved in determining when economic insolvency occurs, and unless the standard can be defined with reasonable specificity, the wresting of ownership rights from shareholders is almost certain to result in litigation.

Second, the proposal to permit a federal insurance agency to take control of a bank and arrange a merger is basically a proposal that federal insurers be given the authority to close the bank. There is no problem with this proposal with respect to federally chartered banks, but as regards state-chartered banks, this authority has always rested with the state banking authorities. Giving closing authority to a federal insurer requires an override of the states' authority in this area and would represent a further assault on the dual banking system.

This problem is not insurmountable, but its solution requires that a reasonably specific definition of economic insolvency be formulated. If such a standard were developed, some form of arrangement might be worked out with state authorities that would enable minimum federal standards, below which no federally insured bank could operate, to be set. State regulators could retain the authority to close a bank before the minimum standard was reached, but would be required to close the bank once the minimum level was reached. But without a specific standard that enables state authorities to know when a federal insurer will force the bank to close, federal insurers would have very broad discretion to override state authority in this area.

Thus, permitting federal insurers to close a bank when it is economically insolvent clearly has merit from a deposit insurer's viewpoint, but the mechanics present some difficult, though perhaps not insurmountable, problems.

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2. If the burden of mismanagement were placed squarely on the managers and stockholders and most failures were handled through a purchase and assumption at an earlier stage - immediately or through a conservatorship - regardless of size - wouldn't this dispose of the fairness question as it relates to large and small institutions? Why couldn't a Continental type solution be applied to failing small banks? If an insurance agency is funded totally by institutions is there a federal subsidy?

Making sure that managers and stockholders of failed banks pay the price for failure represents appropriate public policy because that mimics the typical result in the non-regulated sectors of the economy. That bank failures are frequently resolved through assisted mergers or acquisitions rather than through dissolution should not relieve owners and managers of banks of the penalties normally suffered in private markets. However, such treatment does not dispose of the fairness question if depositors and creditors are not treated the same in large bank and small bank failures.

The so-called fairness question with respect to the handling of failures of large and small banks, in fact, relates primarily to how depositors are treated and to some degree how creditors are treated. The key problem is that if creditors and uninsured depositors suffer no losses in the failure of large banks, then large banks will be better able to attract credit and deposits. The consequences are that large banks will have competitive advantages over small banks, and that medium-size banks will have an incentive to become large, with possible adverse consequences on the concentration of banking assets.

Clearly, there are two ways to achieve equity of treatment. The first is to treat all failures as Continental Bank was treated — in effect, to provide 100 percent deposit insurance. Such a policy eliminates market discipline entirely; obligations of banks generally become preferred over obligations of

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non-banks, the banking industry becomes a more important financial intermediator at the expense of the non-bank financial industry, and the federal insurers incur higher losses than they otherwise would.

The second way is to impose losses on creditors and uninsured depositors by establishing a policy of "modified payouts," or otherwise requiring them to share on a pro rata basis in the losses incurred by the federal insurer. The problem with this solution is that it risks increasing instability in the banking system. A creditor or uninsured depositor has no incentive to maintain any withdrawable funds in a bank whose solvency is suspect. A run on a bank, particularly a large one, by creditors or depositors with large balances may have consequences for consumers, businesses, and other banks that carry the seeds of an old fashioned liquidity crisis of the kind that leads to a general collapse of credit.

Some have argued that such consequences are not inevitable, that the funds that flee from a troubled bank are redeposited elsewhere with no net liquidity drain from the banking system. Such flights, it is argued, are different from the flight to specie that characterized the banking crisis of the 19th century or the flight to currency that characterized the banking crisis of the 1930s. It is further argued that any strains caused by the redistribution of reserves that might attend a professional run on a large bank could be adjusted for by the Federal Reserve. While, as a technical matter, the argument is correct, I have doubts that the adjustments would take place as smoothly as is suggested. The failure of a large, well-known bank that was triggered by a run would shake public confidence, and might well trigger flights to currency and precious metals.

Continental was clearly the opportunity presented at the right time to have established a public policy of market discipline by depositors. The logic of the modified payout would have dictated a closing of the bank, the imposition of losses on creditors and large-balance depositors, the possible failure of some of these creditors and depositors (some of which might be banks), and Federal Reserve protection of solvent banks through the provision of liquidity in the event that any might become subject to irrational runs by their depositors.

It would be interesting to know why the FDIC failed to follow through on its then strongly-held views favoring the modified payout. What role did the Federal Reserve play in helping determine the FDIC's final decision, and what were the considerations that determined the Federal Reserve's position? And, finally, were such considerations that determined the FDIC's and Federal Reserve's positions unique to Continental, or were they so general that for all practical purposes losses may not be imposed on creditors and large depositors at large banks? If the latter, then either we must accept, de facto, 100 percent insurance, or inequities in the treatment of large banks and small ones with the consequences spelled out earlier.

A word about market discipline. There is at present a disincentive to keep uninsured funds in a weak bank that might fail, even if the manager of such funds believes that in the event of failure, he or she will be made whole. First, the manager cannot be sure that is the case; second, if the bank closes, the manager may not have access to the funds for some period; third, if the bank fails, the manager may be embarrassed before superiors for having run risks that were unnecessary; finally, the cost of safety -- simply moving the accounts to a stronger bank -- is virtually nil. I assume, therefore, that treasurers of

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companies and governmental entities favor financially strong depositories; that presumption is consistent with the success of the many services that rate banks.

Thus, I believe we do have market discipline. Weaker banks probably have a lower level of deposits than they otherwise would, or have to pay more for deposits and credit than they otherwise would. To the extent that profit levels of these banks are depressed, I suppose that bank management is induced to address problems of excessive risk. However, the discipline, while it may be there, does not seem severe enough to keep some bankers from taking excessive risk, and is not effective at all in protecting a bank against judgments that seemed sound when made, but were proved by events to be impaired. The point is that we may be underestimating how much market discipline is being effected, and overestimating how much good it can do. Whether the certainty of loss to large depositors in failed banks would make them more effective monitors is hard to say. It would certainly initiate the runs earlier and make them more massive.

You ask whether a federal insurance agency funded totally by institutions provides a federal subsidy. It does. The credibility of the FDIC and FSLIC rests squarely on the presumption that the United States will support the Funds if they were to become unable to meet their deposit insurance responsibilities using their own resources. The Congress indicated as much in its joint resolution in 1982, which though it was not law and not binding on any other Congress, nonetheless recognized a commitment that everyone takes for granted. Indeed, if that were not the case, we would have witnessed massive drains of deposits from FSLIC-insured institutions.

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The subsidy, of course, is not a cash payment, but it is the value of a guarantee and is realized by the lower rates that federally insured banks pay for deposits and credit than other bidders for funds. Consider, for example, that except for the period when banks were attempting to establish market share of money market deposit accounts, banks pay less for such deposits than money market mutual funds pay for shares. Part of the difference may represent the convenience of having a local depository, but part also reflects the benefits of federal insurance.

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3. Is there a place for self-regulation in the banking industry that draws on the talent within the industry? If so, how could concepts of self-regulation be included in the federal supervisory system?

The idea of some form of self-regulation in the banking industry has a great deal of appeal. There is a wealth of talent in the banking industry, and the ability to draw on that talent can only improve the regulation of financial institutions.

There are models of self-regulation that have worked well, NASD and the stock exchanges being the most visible examples. But banking is an industry that cannot afford experimentation with self-regulation in any broad-scale way. The price of failure is simply too high.

The use by federal agencies of industry representatives on advisory boards, in developing and assisting in remedial solutions, and in other consultative-type capacities is probably the most obvious way to make use of industry talent. This approach has been used in several industries, including banking.

One possible approach that does not necessarily involve self-regulation but that would make use of of industry talent in the regulatory process would be to involve industry representatives in a meaningful way in the drafting of regulations. The current practice of solicitation of comments on proposed regulations attempts to do this, but a significant drawback is that once the initial regulations are drafted, the inclination of the regulators is to adjust but not to revamp. Having been a federal regulator, I do not feel that it is an unjust criticism that the drafters of federal regulations often have less knowledge of bank operations than necessary (just as bankers have little appreciation of the difficulties involved in drafting broad-based, enforceable regulations). Input from industry representatives at the earliest stage of the regulation drafting process might very well improve the final product.

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4. Should CPA audits be required of all depository institutions and their holding companies? What steps, if any, should be taken that would permit federal bank examiners to place more reliance on auditors' evaluations of management systems and controls? Would this help examiners focus on asset quality, and bank risk levels, etc.?

It is my opinion that CPA audits should be required of all depository institutions and their holding companies. CPA audits represent an independent investigation into the workings of the institution and, as such, contribute to knowledge about the institution and further the regulatory process.

The question posed suggests that a division of labor between CPAs and bank examiners, with the auditors focusing on management systems and controls and the examiners focusing on asset quality and risk, might be appropriate if greater reliance could be placed on the auditors' reports. While I see no problems with this approach, I would not view it as a critical division of labor.

The question seeks to arrive at a more effective way of protecting depositors' funds, and it assumes that if examiners were freed from having to review management systems and controls, they could do a more effective job of evaluating asset quality and risk levels. However, it is my belief that, as a general matter, bank examiners already do a pretty good job of evaluating asset quality and risk levels under the current arrangement. There are exceptions, but more often than not, the problems arise because the bank examiner's findings are not acted upon rather than because the problems were not known. The Home State debacle in Ohio is the most glaring recent example.

If improving the protection of depositor funds and of the insurance funds is the issue, I believe that both CPAs and bank examiners should place a greater emphasis on uncovering instances of fraud. Bank problems relating to asset

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quality and risk are generally known about by regulators for some time, and they normally have adequate time to take actions to resolve the problems if they act resolutely. On the other hand, fraud, by its nature, is secretive and may generate massive losses before it is discovered. FDIC losses have been the greatest in cases of fraud; recent examples are Penn Square and the Butcher banks in Tennessee. Bank examinations and mandatory CPA audits of all depository institutions and their holding companies, both with an increased emphasis on uncovering fraud would, in my opinion, contribute importantly to protection of depositors' funds and of the insurance funds.

5. What is your view of permitting federal regulators to require institutions to pay special assessments for the increased examinations made necessary by their classification as a problem institution?

The costs of running a banking agency can be broken down into two parts, direct costs and overhead. Direct costs are those attributable to work done for individual banks and include costs of examination and costs of processing applications. Overhead costs are those not directly attributable to work done for individual banks. Overhead costs should be covered by pro-rata assessments based, for example, on asset size. Direct costs should be paid by the individual banks that occasion them. I am therefore in favor of permitting federal and state regulators to require institutions to pay special assessments for the increased examinations made necessary by their classification as problem institutions.

The counter argument is that, for problem banks, paying these costs burdens the bank with additional expenses when it is least able to afford it. However, the costs involved are not that great and they do not have any significant impact on the condition of the bank. Having to pay them may also act as an incentive to operate in a safe and sound manner to avoid such additional costs.

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6. If regulators are rarely surprised by a bank failure - isn't the answer swifter or more appropriate regulatory action rather than increased market discipline? Wouldn't giving the regulators the ability to close an institution earlier be appropriate? Should a regulator require bank management to file a confidential bank failure plan approved by its board of directors if it falls a certain percentage below its minimum capital level for a specfied period of time?

I am inclined to agree that swifter action by regulators would be beneficial in avoiding bank failures or limiting the losses to the insurance funds that arise in bank failures. If appropriate regulatory action is taken in a timely way, it would in general be superior to the effects of market discipline. Unfortunately, we have frequently witnessed a lack of will on the part of regulators to take action even in the face of definite knowledge of unsound, failure-threatening behavior of bank managements, most recently by the regulators and private insurers of non-federally insured institutions in Ohio and Maryland.

I would add that while regulators are rarely surprised by a bank failure, they are often surprised by the extent of loss. Fraud, as indicated, is concealed, and it is only after the regulator begins to take aggressive investigatory action, even beyond the normal investigations of the routine bank examinations, that the full extent of problems and losses become known. That being the case, it further argues for swifter, more appropriate regulator action.

With respect to giving regulators the ability to close an institution "earlier," it is my impression that most chartering agencies have sufficient authorities at present. Typically, state commissioners are held to a "danger of failing" standard or "operating in an unsafe and unsound manner" standard. Such

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phrasing gives a commissioner sufficient leeway in timing the closing of a bank. The commissioner must, of course, be able to sustain his judgment in court so as to protect the private property rights of stockholders of a foundering institution. However, the courts are not inclined to find against a commissioner who has a reasonable case under the statutory standard.

In Massachusetts, the commissioner has announced that he will close any bank whose bank capital to assets ratio falls below three percent. While he has not had to do so, I have no doubt that he would be sustained if his standard were challenged. While a three percent bank capital standard may, for thrift institutions, represent a negative capital ratio on a market value basis, it is, nonetheless, an aggressive standard by comparison with other jurisdictions, and one that would help limit the losses of a deposit insurer.

7. With regard to the concern that some states may have expanded banks' product authorities beyond what may be prudent, can this issue be dealt with by giving the federal insurance agencies the authority to require a prudent level of capital to support that activity in order to maintain insurance - rather than giving any federal agency the authority to override a state legislature? In other words, wouldn't the adoption of risk-based capital standards go a long way toward solving this problem?

The most important element of the dual banking system is the authority of states to determine the activities of the banks they charter. This authority has vitalized the banking system in the United States, being responsible for branching, NOW accounts, and variable rate mortgages, among other innovations. If in the interests of protecting the federal insurance funds, we were to give up the possibility of future such innovations, we would be giving up far more than we gain. The judgment of how well our banking system operates rests on how well it serves the public, and we should not lose sight of that as we wrestle with the issue of how to protect the insurance funds.

The knee-jerk reactions of the agencies to one or another activty that states may allow for the banks they charter or to innovations that the markets develop does not give much comfort that the vitality of the banking system is given much weight. The rush to eliminate the ability of South Dakota to allow its banks to offer insurance services nationwide is a case in point. The issue is whether a bank offering such insurance services is subject to unreasonable risk. That issue was not really addressed. Rather the movement to bar South Dakota banks from exercising such powers proceeded from a desire that the issue of whether banks should offer insurance be settled at the federal level.

Brokered deposits do not cause bank failures; it is the imprudent investment of deposits, brokered or otherwise, that causes failure. To be sure, brokered deposits <u>may</u> be a symptom of developing problems in an institution, but

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suppressing the symptom is not a reasonable response, especially if in many cases the symptom is a false one. The reasonable reaction would have been to investigate those banks that were using large amounts of brokered funds to determine which of them were, in fact, in trouble, and to take action with respect to those that were.

In any case, adopting risk-based capital standards that would allow banks to engage in activities that are otherwise legally granted to them is superior to restricting such activities by regulation. In that way the agencies establish a "price" for operating in such markets, leaving to the institutions the judment as to whether the "price" is worth the privilege, whether the privilege is engaging in insurance activities, taking brokered deposits, or making direct investments in real estate activities.

Establishing risk-based capital standards has the benefit of requiring the agencies to consider explicitly the meaning of risk in a systematic way and that would be far superior to their ad hoc reactions to this activity or that one. Indeed, it would lead, I believe, to the explicit recognition that bank risk is a function of how diversified a bank's activities are and is not determined by whether it engages in one particular activity or another. Real estate development or the holding of equities, for example, both high risk activities, will reduce bank risk if engaged in prudentially and to a limited degree. On the other hand, agricultural lending, an activity of inherently reasonable risk, becomes high risk when it constitutes too great a fraction of a bank's loan portfolio as it does for many "agricultural banks" in the Midwest, or constitutes the entire portfolio, as it does for the Farm Credit System.

In summary, the development of risk-based capital standards may be difficult, but it appears to be worth the effort.

The CHAIRMAN. Next I'd like to invite Mr. Bert Ely and Mr. Charles Filson to the witness table.

Mr. Ely, would you like to begin, please.

STATEMENT OF BERT ELY, PRESIDENT, ELY AND CO., INC., ALEXANDRIA, VA

Mr. ELY. Mr. Chairman, I want to thank you for inviting me to testify today on depositor protection reform.

[The complete statement follows:]

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A STATEMENT ON

DEPOSITOR PROTECTION REFORM

Presented to the

COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
of the
UNITED STATES SENATE

by

BERT ELY
ELY & COMPANY, INC.
803 PRINCE STREET
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Room SD-538
Dirksen Senate Office Building
July 31, 1985
9:30 a.m.

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Mr. Chairman, members of the Committee, thank you for inviting me to testify on depositor protection reform.

We have taken banking deregulation half way across the stream. As the water rises around us, now is the time to forge on, for there is no turning back. Attempts to contain federal deposit insurance losses through reregulation will drown us all. We will reach the far edge of the stream only by completing the deregulation process, and privatizing depositor protection.

Deregulated banking needs effective depositor protection just as much as regulated banking needed it. But the forms and means of protection must differ. Depositor protection must now rely on the marketplace; it must truly reward prudent bankers while penalizing the reckless.

The rapid weakening of the Federal Savings and Loan Insurance Corporation argues strongly that federal deposit insurance is hopelessly structurally flawed. The failure of private deposit insurers in Ohio and Maryland, far from invalidating private sector depositor protection, merely shows how not to structure it. It is premature to reject all forms of private protection.

I am here today to present a private sector depositor protection proposal, called depository cross-guarantees, that will offer superior protection under all economic conditions.

Privatizing depositor protection

Briefly, the depository cross-guarantee concept is self-insurance tailored to the era of deregulated banking. The deposits of each American depository institution -- the guaranteed depository -- would be fully guaranteed by other depository institutions -- the guarantors. The federal government,

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rather than acting as direct insurer, would supervise the cross-guarantee process much as the Securities and Exchange Commission polices the financial markets.

This proposal, described more fully in the attached Appendix A, would meet the tests of acceptability that every depositor protection program, or proposal, should meet.

Cross-guarantees would very clearly differentiate between the two risks facing all depositor protection plans.

The first risk is the liquidity risk, the risk that a bank run or widespread banking panic will drain so much cash from banks or S&Ls that they can no longer honor withdrawal demands. But this is a pseudo risk because the Federal Reserve, America's lender of last resort, loses no money in covering these runs, just as it lost no money covering the runs on Continental Illinois or the Ohio S&Ls.

The second risk, the real depositor protection risk, is the insolvency risk, the risk that a failing depository's liabilities will exceed the market value of its assets. Here, the insurers, or guarantors in the case of cross-guarantees, advance monies they will never recover.

Differentiating between these two risks is crucial to shaping any depositor protection proposal, or evaluating the existing deposit insurance programs. Unfortunately, few make this distinction.

Seven premises on which to base depositor protection

Any valid depositor protection mechanism -- public or private -- must be built on the following seven premises. Section II of Appendix A discusses these premises in greater detail. The cross-guarantee concept builds on each of them.

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First premise. Cross-guarantees would protect every dollar of deposit in every depository institution; not just the first $100,000, but every penny.

All attempts to foist insolvency risks upon depositors are doomed to failure because depositors are creditors, not stockholders. Depositors don't fight to lessen a depository's riskiness. Instead, they run at the first sign of trouble because by staying they gain nothing that they cannot get elsewhere. Putting large depositors at risk encourages very destructive instability in failing institutions, further weakening them.

The Continental Illinois run last summer dramatically illustrated the destabilizing actions of uninsured depositors as billions fled from the bank. That run increased any insolvency loss the Federal Deposit Insurance Corporation (FDIC) incurs in Continental by at least $100 million.

Second premise. Depository institutions would pay risk-sensitive premiums for their cross-guarantees. These premiums would pass four tests: One, they would be calculated and paid contemporaneously, based on leading indicators of banking risk. This would force depository managements to factor the cost of depositor protection into their decision-making.

Two, these premiums would vary over a very wide price range. Based on a recent Federal Reserve study, they would range from a few basis points annually (one basis point = .01%) to more than 500 basis points! Three, the premium formula would be dynamic so that it would measure everchanging perceptions of banking risk. Four, a competitive, commercial marketplace, with multiple buyers and sellers, would establish these premiums.

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While many advocate risk-sensitive premiums for the federal deposit insurers, only a competitive marketplace can set legitimate prices. Risk-sensitive premiums set by the federal deposit insurance monopolies would be economically arbitrary by virtue of being established in a political, not a commercial marketplace.

Third premise. Guarantors would minimize insolvency losses by taking over and selling or liquidating failing depositories before they became insolvent. Nominal insolvency losses therefore are realistic, as history shows. Despite some large failures, FDIC insolvency losses in commercial bank failures have realistically averaged 10% to 15% of total deposits. Even during the great banking collapse of 1930-33, depositor losses, $10.7 billion in 1985 dollars, averaged just 19.6% of their deposits.

Low losses should occur because depository institutions are collections of risks -- loans, investments, depository instruments, etc. They are not one big risk, such as an airplane or a large building. Consequently, there is no such thing as a total loss in a bank failure.

Fourth premise. Cross-guarantees would tailor equity capital requirements to the unique riskiness of each depository institution. Each depository would negotiate this requirement with its guarantors.

Regulators continually argue for uniform, and increasingly higher, capital standards. Nothing could be more unrealistic as uniformity ignores the growing diversity of banks and S&Ls.

Recently, The Wall Street Journal reported that foreign banks are increasing their activities in America, in part because their governments permit them to operate with less equity capital. Flexible capital standards, coupled with risk-sensitive premiums,

would enable our well-managed banks to compete effectively against these foreign banks.

Fifth premise. Guarantors would closely monitor the riskiness of the depository institutions they guarantee since they would be next in line, after stockholders, to absorb insolvency losses. This monitoring process would be integral to the risk-sensitive premium calculation process. Continual monitoring would replace infrequent bank examinations.

Sixth premise. Cross-guarantees would not require any participation by property/casualty insurers. For numerous reasons, insurers now abhor depository institution insolvency risks even though this type of risk is superior to many of the risks they now assume. Appendix A sets out these reasons. Eventually, as insurers gain a better understanding of the insolvency risk, they might become more receptive to insuring it.

Seventh premise. The banking industry has an adequate capital base over which to spread its insolvency losses. Even if all depository institution asset losses were recognized today, depositories would still have total equity capital of at least $120 billion. This is more than one hundred times the capital the industry would need to self-insure itself, based on the concept of the "cushion ratio." The cushion ratio equals annual insurance losses divided into the capital base available to absorb those losses.

The property/casualty insurance industry has historically operated with a "cushion ratio" of less than one. Once accumulated insolvency losses within depository institutions have been recognized, and with the advent of valid risk-sensitive premiums, depositor protection insolvency losses should drop well below

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$1 billion annually. Thus, the banking industry's cushion ratio would rise well above 100 to 1. Alternatively, its equity capital could be reduced to hold the ratio at 100 to 1. This ratio far exceeds the capital required to absorb losses of the magnitude experienced during 1930-33.

Conclusion

Enabling legislation implementing depository cross-guarantees would permit banks, S&Ls and credit unions to opt out of federal deposit insurance. A sunset provision would eventually force all depositories to obtain cross-guarantees. There would be no need for a federal deposit-insurer-of-last-resort.

The cross-guarantee concept differs significantly from the failed private deposit insurers in Ohio and Maryland. The attached Appendix B is a reprint of an article I wrote several months ago for the American Banker outlining the structural flaws that undermined the Ohio Deposit Guarantee Fund.

Mr. Chairman, members of the committee, thank you for your time.

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APPENDIX A

A paper, as revised for publication, presented to the
Conference on Bank Structure and Competition
sponsored by the
Federal Reserve Bank of Chicago
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YES - PRIVATE SECTOR DEPOSITOR PROTECTION IS A VIABLE ALTERNATIVE TO FEDERAL DEPOSIT INSURANCE!

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Private sector depositor protection, properly structured, is still a viable alternative to federal deposit insurance. The recent failure of the Ohio Deposit Guarantee Fund (ODGF), far from invalidating every private sector alternative, merely shows how not to structure one.[1]

This paper first assesses the two very different risks present in the depositor protection function. It then discusses seven premises on which private sector depositor protection must be based, followed by a specific proposal quite different from any existing public or private depositor protection scheme. It also addresses two related issues: capital adequacy and catastrophic losses.

Currently, three federal agencies dominate deposit insurance. They are the Federal Deposit Insurance Corporation (FDIC), the Federal Savings and Loan Insurance Corporation (FSLIC) and the National Credit Union Share Insurance Fund (NCUSIF). Twenty or so private firms, insuring several hundred savings and loans and 3,100 credit unions,[2] provide the remaining deposit insurance coverage.

The term "depositor protection," instead of deposit insurance, will be used where suitable since depositors can be protected by means other than insurance.

I. The Two Depositor Protection Risks

Two risks - one pseudo and one real - are inherent in all depositor protection programs. The pseudo risk is the liquidity risk, the risk arising out of a bank run or a widespread banking panic. The real risk is the insolvency risk, the risk that a failing depository's liabilities will exceed the market value of its assets. Differentiating between these two risks is crucial to understanding the depositor protection problem. Unfortunately, few make the distinction.

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Last year's run on Continental Illinois and the recent run on the privately-insured Ohio S&Ls dramatically illustrate liquidity risk. However dramatic a bank run may be, though, the liquidity risk is still just a pseudo risk. Properly managed, this risk is not a real risk to the depository experiencing a bank run, to its depositors or to its lender of last resort.

The following questions will reinforce this point: how much money did or will the Federal Reserve, America's lender of last resort, lose as a result of advancing $7.6 billion to Continental Illinois?[3] By advancing $70 million to the Ohio S&Ls?[4] The Fed will lose not a penny of principal in either case because all of its advances have been fully collateralized.

The key point is this: If the lender of last resort is repaid all its advances, the liquidity risk is nothing more than a temporary liquidity strain. On occasion, the strain can be very severe, but still manageable. If the lender earns a market interest rate, this risk is costless to all concerned since the funds the lender advances merely replace funds withdrawn by others.

This leads to the insolvency risk, the real risk in the depositor protection function. Insolvency losses, not illiquidity, wiped out Home State Savings Bank, the Butcher banks, and the First National Bank of Midland, to name a few. FDIC losses, if any, in the Continental Illinois case will be an insolvency loss. The losses that have bankrupted so many S&Ls, and effectively the FSLIC, are insolvency losses, not the costs of illiquidity. The real challenge, therefore, to any depositor protection program is managing the insolvency risk.

II. Premises

Seven premises underlie the private sector depositor protection proposal presented in the next section. Many of these premises differ from conventional thinking on this topic. These premises are as follows:

One, every depository institution, whether a commercial bank, thrift, credit union, or depository holding company, is a collection of risks, not one big single risk. Specifically, depositories are pools of different types of investments, thousands or hundreds of thousands of loans, and numerous deposit and purchased money instruments. By contrast, a large factory building, a Boeing 747 or a space satellite is a large single risk.

This distinction is crucial when evaluating the potential for an insurance loss. If a single risk is completely destroyed, its insurer experiences a total

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loss. Deposit insurance insolvency losses in a failed depository, however, almost always are a small fraction of the total amount of deposits. From 1934 to 1983, for example, reported FDIC and uninsured depositor losses in commercial bank failures averaged 9% of total deposits in the failed banks.[5]

Two, the recently promulgated increases in capitalization requirements for depositories will not lessen their insolvency risk. A higher capital requirement translates into lower capital leverage. This, in turn, means a lower return on equity capital. Management, however, will seek to offset this lower return by pursuing higher yielding, and therefore riskier, loans, investments and funding strategies. These compensating actions will, in turn, largely if not totally negate the sought after benefits of higher capital.

As deregulation fosters increased heterogeneity among depository institutions, uniform capital standards become increasing invalid. The challenge to the depositor protection process, therefore, is tailoring each depository's capitalization requirement to its unique risk characteristics.

Three, every dollar of deposit in every depository institution should be fully protected from loss of principal and interest, for two reasons.

First, uninsured deposits create banking instability, which in turn threatens the smooth functioning of the payments system. The Continental Illinois run last summer dramatically illustrated the instability of uninsured deposits as billions fled from the bank, with worldwide ramifications.[6] Again this spring, $260 million of deposits ran from the privately-insured Ohio S&Ls, including $154 million from Home State.[7]

Second, depositor monitoring is ineffective because it falsely assumes that depositors, acting like stockholders, will force high-risk depositories to clean up their acts. Depositors, however, have no upside disciplining incentive, such as the opportunity for higher interest rates or principal appreciation. Instead, they run at the first sign of trouble. Those who aggressively monitor their depositories merely run sooner. Troubled depositories, forced to pay above-market interest rates on their liabilities, often try to compensate with higher yielding, and of course, riskier loans and investments. Sometimes they even try to survive with reduced equity earnings.

Four, a competitive, commercial marketplace must establish risk-sensitive depositor protection premiums, calculated and paid monthly. There are three reasons for this.

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First, the present flat-rate deposit insurance premiums encourage and finance hazardous banking through the cross-subsidization of crap shooters by sound, prudent bankers. The moral hazard so often attributed to deposit insurance results from these flat-rate insurance premiums, not 100% deposit protection.

Second, monthly premium payments would brake unrewarding banking. These contemporaneous premiums would integrate the cost of depositor protection into a depository's total funding cost. They would be calculated from appropriate leading indicators of banking risk designed to measure each bank's unique and everchanging degree of risk. The marketplace discipline of risk-sensitive premiums would encourage depository managements to make sounder lending and funding decisions at the margin. Lower depositor protection insolvency losses would follow.

Third, only a competitive marketplace can set legitimate prices. Further, both buyers (depositories) and sellers (insurers) must have alternatives and roughly balanced negotiating power if that marketplace is to function efficiently.

By contrast, risk-sensitive premiums set by the federal deposit insurance monopolies would be economically arbitrary by virtue of being established in a political, not a commercial marketplace. Therefore, these premiums will never be properly priced as a government monopoly cannot mimic a marketplace.[8]

Five, those with equity capital at stake — stockholders, insurers, or guarantors — must monitor depository risks, for these parties have the most to lose if there is an insolvency loss since their investments are subordinate to the claims of depositors and other creditors. This ongoing monitoring process is also integral to the premium calculation process: the premium charged against the depository would reflect a bottom line assessment of that depository's riskiness.

Six, private insurance companies are unlikely providers of deposit insurance for the entire banking industry even though they now provide limited reinsurance to a few private deposit insurers. In fact, it is neither necessary nor feasible to look to the property/casualty insurers to provide any insolvency protection for depository institutions.

It is not necessary because the banking industry has ample equity capital to support a very solid depositor protection program. At the end of 1984, the book net worth of all U. S. depository institutions was approximately $200 billion.[9] If these institutions marked both their assets

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and their liabilities to realistic values, they might reduce their combined net worth by 40%, or $80 billion.[10] Even so, the industry would still have a collective net worth of $120 billion.

By comparison, at the end of 1984 property/casualty insurers had approximately $63 billion[11] of "policyholder's surplus" (a conservative, statutory method of accounting for insurance company net worth). The federal deposit insurers had $24 billion of fund balances (unencumbered reserves) on that date.[12] If the FDIC and the FSLIC properly reserved for prospective losses from reasonably anticipated failures, as does the NCUSIF, their reserves would probably equal half that amount.

Clearly, the banking industry has far greater capacity to insure itself than is available elsewhere. It has twice as much effective capacity as the property/casualty insurers and ten times as much as the federal deposit insurers.

The insurance industry also is not a feasible source of depositor protection, for many reasons. First and foremost, individual risk exposures in depositories absolutely boggle insurers, and their regulators. A $500 million loss exposure is a big property/casualty risk, yet in the banking industry, $5 billion maximum exposures are not uncommon. The very biggest approach $100 billion.[13] Unfortunately, insurers and regulators do not understand the depository insolvency risk, specifically that banks can fail with little, if any, insolvency loss.[14]

Insurance companies often cite inadequate capacity, the inability to assume insurance risks beyond an aggregate amount, as another reason they cannot insure bank deposits. However, the regulations governing insurance capacity assume 100% losses in failed banks. There is adequate capacity, though, if potential losses are realistically assessed and the lessons of the 1930-33 banking collapse are properly understood.

Insurers are also very leery of the liquidity risk. Illiquidity, however, would not threaten any insolvency insurer if the Federal Reserve provided an unimpeachable and legally enforceable commitment to supply the liquidity needed to arrest a bank run.

Two unfortunate characteristics of property/casualty insurers militate against a major role for them as deposit insurers. First, the premiums they charge tend to fluctuate year-to-year much more than their actual loss experience. For instance, last year insurers were selling many coverages at or below cost to obtain cash flow for investment purposes. Today, after a disastrous 1984,

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insurers are boosting premiums 25%, 50% or more from last year's levels.

Second, insurers tend to abandon or at least retreat from an insurance market if they have a spate of losses in that market. Thus, they could not be relied on year in and year out to provide adequate amounts of deposit insurance to the banking industry.

Finally, insurance regulators do not want insurers to take on a lot of banking industry risk. Their strong reaction last year against CIGNA's currency inconvertibility insurance policy for Citicorp clearly illustrates this point. Lloyd's of London, still the world's principal reinsurance market, also has a very strong bias against almost any kind of financial guarantee insurance.

Seven, credible depositor protection must have an adequate capital base over which to spread insolvency losses. The "cushion ratio" best measures this adequacy. It is the ratio of the equity capital available to absorb losses divided by the amount of annual insolvency losses.

The following describes the significance of the cushion ratio. As suggested previously, the total net worth of all depository institutions might drop to $120 billion if their assets and liabilities were marked to market values. Recent history also indicates that insolvency losses should drop well below $1 billion annually once accumulated insolvency losses are acknowledged and dealt with.[15]

With a marked down net worth of $120 billion and annual insolvency losses under $1 billion, the banking industry would have a "cushion ratio" in excess of 100 to 1.[16] By way of contrast, in 1983, the most recent year for which figures are available, the cushion ratio for the American property/casualty insurers was just .75 to 1.[17] Quite a contrast with a 100 to 1 ratio!

Clearly, the banking industry has more than enough equity capital to absorb its insolvency losses. The next section describes a self-insurance mechanism for the banking industry that would utilize this capacity to insure.

III. The Cross-Guarantee Concept

Very briefly, every depository institution operating in the United States would protect all its deposits with cross-guarantees from other depositories. The exhibit on the next page illustrates the cross-guarantee concept in a highly simplified fashion. It shows two important features about cross-guarantees.

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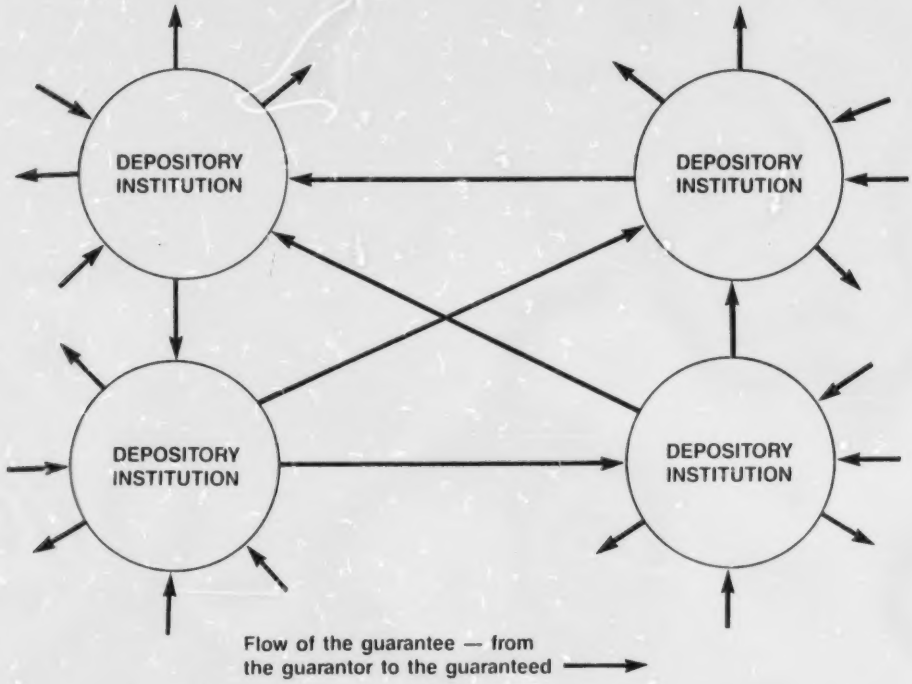
THE CROSS-GUARANTEE CONCEPT—ILLUSTRATED



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First, each depository would be guaranteed by many others. This would disperse insolvency losses over many guarantors. A wide dispersion of losses would, in turn, prevent any one banking failure from causing subsequent failures in a domino-like fashion, particularly if a large depository failed with a big insolvency loss.

Second, guarantees would be structured in a round-robin fashion. Thus, one depository would not be both a guarantor and a guaranteed of a second depository. This would prevent excessive concentrations of risk.

The cross-guarantee concept parallels the capital structure at Lloyd's of London, which has operated continuously, and profitably, for almost 300 years. Cross-guarantees also bear a strong resemblance to standby letters of credits issued by banks.

With cross-guarantees, a guaranteed depository could draw capital from its guarantors only in the event of failure, and only to the extent of its insolvency loss. Thus, guarantors would only be contingently liable to their guaranteed depository until the guarantee was actually drawn upon.

Cross-guarantees would be negotiated in a competitive marketplace comparable to Lloyd's. The guarantees for large and medium-size depositories would probably be syndicated to guarantors on an institution-by-institution basis. Guarantees of smaller, geographically dispersed depositories might be syndicated on a group basis to reduce underwriting expenses.

There would be four parties to each cross-guarantee contract: one, the depository to be guaranteed; two, the depositories or other parties that will become the guarantors; three, the agent who organizes and administers the syndicate. This agent would also monitor the guaranteed depository, collect the guarantee premium and distribute it to the guarantors. The most likely agents are insurance brokerage firms.

The fourth, and perhaps most important party to each cross-guarantee contract would be the Federal Reserve. By signing a contract, the Fed would give its unqualified and legally enforceable commitment to unconditionally fund any run on the guaranteed depository. At the same time, the guarantors would give their unqualified commitment to protect the Fed from losses on funds it advanced to the guaranteed depository. Protecting the Fed against losses insures that taxpayers will not indirectly subsidize bank insolvency losses through the Fed.[18]

Each cross-guarantee contract would include the following provisions: the formula for calculating the premiums paid by the guaranteed institution, the manner in

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which the agent would perform its monitoring duties, negative covenants and events of default, and cancelation and renewal terms. Most banking regulation, particularly that which applies to balance sheet management, would be replaced by the negotiated terms of these contracts.

A cross-guarantee contract would run for three years, subject to any party canceling it upon three or six months' notice. If canceled, the guarantors would be responsible for protecting the depositors in the guaranteed institution until it found new guarantors. If the depository could not obtain new guarantors, the existing guarantors would take it over and either sell it, recapitalize it, or in a worst case situation, liquidate it. In any case, the guaranteed depository would have failed. Its depositors, however, would be fully protected at all times.

Each guarantor of depositories would, in the true insurance fashion, be taking a small piece of many risks. Consequently, each guarantor would receive a continual stream of premiums while also absorbing its share of the occasional insolvency loss. Most guarantors in most years would net a positive cash flow from their guarantor activity. That return would compensate them for having assumed the contingent liabilities associated with being a guarantor. This, of course, is precisely how the 26,000 Lloyd's members hope to earn a return for their commitment to the Lloyd's underwriting syndicates to which they belong.[19]

The cross-guarantees enabling legislation would establish an opt-out mechanism to permit depositories to drop their federal deposit insurance upon obtaining deposit guarantees. The existing federal deposit insurance funds would be liquidated after a five to ten year transition period. By then, all depository institutions would have obtained guarantees or been liquidated or merged. There would be absolutely no need for a federal deposit insurer-of-last-resort.

One question remains: Why should depositors place as much confidence in cross-guarantees as they currently place in federal deposit insurance? Depositor confidence is simply based on this knowledge: Money can be withdrawn immediately from a depository checking account or, without delay, when a time deposit matures. The lender of last resort should provide that assurance under <u>all</u> circumstances to every depository, whether protected by a public agency like the FDIC or private guarantors. Thus, the key to public confidence in cross guarantees is an unimpeachable role for the Federal Reserve as the lender of last resort to all guaranteed depositories. The cross-guarantee concept mandates that role for the Fed.

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IV. Capital Adequacy and Catastrophic Losses

In closing, this paper will address two related issues: capital adequacy for the banking industry and catastrophic losses.

Capital adequacy concerns have led to higher capital requirements for depositories. Nonetheless, as shown above, higher capital requirements for individual banks are at best a zero-sum proposition. In actuality, the banking industry is overcapitalized, possibly by a factor of three or four.

Presently, banking risk is focused on each depository's equity capital. The sole backup to that capital, if losses exhaust it, are the relatively small reserves of the depository's federal deposit insurer. The fear is always present, and increasingly with the FSLIC, that large insolvency losses will seriously deplete an insurer's reserves, or even bankrupt it.

Nonetheless, the federal insurers' reserves are not tapped every day since over time only about one depository in two hundred fails in any one year.[20] Even so, this failure rate is higher than it should be because the existing flat-rate deposit insurance premiums encourage excessive risk-taking and consequently an unnecessarily high failure rate.

Cross-guarantees with risk-sensitive premiums would (1) reduce the frequency of failure, (2) reduce the insolvency loss percentage in failures and (3) spread insolvency losses over an at least ten times larger capital base than is now realistically available to absorb losses. As a result, bankers and regulators would become less fearful of the consequences of an individual depository exhausting its capital than is now the case. Industry-wide capital adequacy, measured by the cushion ratio discussed above, would then become the regulators' premier measure of capital adequacy. The capital adequacy of individual depositories would become the province of depository guarantors.

Risk-sensitive premiums and timely monitoring should drop depository insolvency losses, when compared to total depository liabilities, to below one basis point annually (one basis point equals .01%.). This would be less than $300 million in 1985 terms.[21] Banking regulators should also find comfort in a cushion ratio of 100 to 1, or capital 100 times expected annual losses. If these two events occurred, then the entire American banking industry would need just $30 billion of equity capital.[22] That number may sound outrageously low. Nevertheless, the

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American property/casualty insurers protect trillions of dollars of property, plus unquantifiable casualty loss exposures, with a capital base of just $63 billion.

The concern about catastrophic losses arises primarily from the American banking collapse of 1930-33. The losses suffered by both depositors and stockholders during those years were caused almost entirely by the Fed's failure to maintain liquidity within the banking system. This disaster dramatically illustrates why the Fed must enter into legally enforceable agreements whereby it will, in effect, have no choice but to maintain liquidity within the banking system. Very simply, another banking collapse of the magnitude of 1930-33, and the enormous insolvency losses that would accompany it, could not happen again if liquidity maintenance was mandated.

Losses were severe in the 1930-33 period for a second reason. The unit banking and limited branching structure of that era, coupled with the lack of an external, i.e. interbank, risk dispersion mechanism, prevented the dispersion of insolvency losses across the entire capital base of the U. S. banking industry. In this regard, the Canadian banking experience during these years is very instructive. Not only did none of the nine chartered Canadian banks fail during that time, but each one made money, albeit at a reduced rate, during every year of the Depression.[23]

Now, why the difference between the experiences of the two countries? The quick answer: unit banking versus nationwide branching. There is, however, a more subtle answer. The Canadian banks, with their large branch networks, had an internal risk dispersion capability unmatched by a comparable external risk-dispersion process in the American banking system.

Cross-guarantees, though, would provide, on an external basis, the same effective dispersion process that served the Canadian banks so well during the 1930-33 period. In other words, cross-guarantees would permit the preservation of some semblance of unit banking while providing the risk-dispersion fruits now found only in large branch banking systems.

V. Conclusion

The present structure of the federal deposit insurance monopolies encourages excessively risky banking among all types of depository institutions. The regulatory processes designed to minimize the risks threatening the deposit insurance funds have operated with increasing inefficiency and ineffectiveness as banking deregulation has bloomed.

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Because there can be no return to the almost failure-free banking environment of yesteryear, America's depositor protection mechanism must be fundamentally restructured. The new mechanism must optimize banking efficiency in a deregulated environment. It must charge each depository a premium that reflects that institution's everchanging riskiness. It must make bank runs a bygone fear. It must incorporate the flexibility and adaptability found only in private, competitive marketplaces. Depository cross-guarantees could be that mechanism.

Postscript

The Maryland Savings-Share Insurance Corporation (MSSIC), a private insurer of 102 Maryland S&Ls, failed two weeks after this paper was delivered. The MSSIC suffered from the same structural flaws that characterized the ODGF and all the existing private deposit insurers. The MSSIC failed for essentially the same reasons the ODGF failed. The MSSIC failure no more vitiates the cross-guarantee concept than did the ODGF failure.

Several papers in these proceedings merit particular attention with regard to privatizing the depositor protection function. Russell VanHooser and Roger Lumpp, in separate papers, state very eloquently why property/casualty insurers have little interest in deposit insurance. Robert Avery and Myron Kwast present an excellent analysis demonstrating the wide range over which risk-sensitive deposit insurance premiums must fluctuate if they are to properly compensate deposit insurers for the risks they assume. Alan Grunewald and Alex Pollock present interesting reasoning, based on empirical data, explaining why institutional and corporate depositors shun the task of monitoring the banks in which they have large deposits.

Footnotes

1. The author, in an article in the April 5, 1985 issue of the American Banker, described the three structural flaws that undermined the ODGF.

2. Based on annual reports for the private savings bank and savings and loan insurers in Massachusetts, Maryland, Pennsylvania, and North Carolina and the 1984 NCUSIF Annual Report with regard to privately insured credit unions (pp. 16 to 19).

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3. Continental Illinois Corporation, 1984 Annual Report, p. 2.

4. Testimony of Karen N. Horn, President, Federal Reserve Bank of Cleveland before the Subcommittee on Commerce, Consumer, and Monetary Affairs of the Committee on Government Operations, U. S. House of Representatives, April 3, 1985.

5. For the period 1934 to 1983, the FDIC reported losses of approximately $920 million (excluding liquidation expenses and some foregone income) in 654 commercial bank failures. Deposits totaled $10.92 billion in these failures. The FDIC loss equaled 8.4% of the total deposits in these failed banks. Losses to uninsured depositors in these banks raised the total rate of loss to about 9%. These calculations are based on data taken from the 1981, 1982 and 1983 Annual Reports of the FDIC.

These calculations purposely exclude 14 mutual savings bank failures during the 1981-83 period. The author does not consider these savings bank failures to be representative of the insolvency experience a private deposit insurer would experience over a long period of time. Under a system of risk-sensitive premiums, thrifts would be highly unlikely to repeat their funding and fixed-rate mortgage lending mistakes of the past.

The FDIC loss rate probably has been understated until recent years due to deficiencies in accounting for the costs of assisting or liquidating failed banks. According to unpublished estimates, the real FDIC loss rate has averaged 10% to 15% of total deposits in failed banks. During the 1930-33 banking collapse, depositor losses averaged 19.6% in 9,096 failed banks (calculated from data on page 41 of the 1983 FDIC Annual Report). Generally speaking, the smaller the bank, the larger the insolvency loss percentage.

6. From March 31, 1984 to September 30, 1984, a six month period encompassing its big run, Continental Illinois' total deposits dropped from $28.3 billion to $12.2 billion, a deposit loss of $16.1 billion, or 57%. The decline in the foreign component of its total deposits was even more dramatic: it plunged from $18.1 billion to $5.7 billion, a loss of $12.4 billion, or 69%. Data source: Continental Illinois Corporation's first and third quarter, 1984 quarterly reports to stockholders.

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7. Calculated from a chronology appended to the Horn testimony referred to in footnote 4.

8. To this day, one of the best discussions of the shortcomings of risk-based premiums established by the federal deposit insurance monopolies is found in Scott, Kenneth and Mayer, Thomas, "Risk and Regulation in Banking: Some Proposals for Federal Deposit Insurance Reform," Stanford Law Review 23 (May, 1971), particularly at pp. 890-895.

9. The net worth of federally insured U. S. commercial banks and thrift institutions (including credit unions) was $196 billion on June 30, 1984, according to the 1984 Annual Report of the Federal Financial Institutions Examination Council, page 22. The inclusion of net income (net of dividends) of these institutions for the second half of 1984 plus the net worth of depositories not insured by a federal agency brought the book net worth of all U. S. depositories to $201 billion at the end of 1984.

10. Thrift markdowns of their fixed-rate mortgages to current market values would account for most of this amount. The balance is accounted for by (1) increasing loss reserves in the commercial banks to reflect their prospective losses on foreign loans and loans to the energy and agricultural sectors of the U. S. economy and (2) adjusting liabilities to market values. For purposes of this discussion, the author ignores the fact that markdowns of this magnitude would make many depository institutions, particularly thrifts, hopelessly insolvent.

11. "1984 Underwriting Results: An Update," Best's Review, May, 1985, pp. 14-20.

12. Based on the 1983 annual reports for the FDIC and FSLIC, the 1984 NCUSIF Annual Report, and various news stories, the author made the following December 31, 1984 fund balance estimates for the federal deposit insurers: FDIC - $17.2 billion; FSLIC - $5.9 billion; NCUSIF - $1.1 billion, for a total of $24.2 billion.

13. The two biggest deposit exposures at the end of 1984 were BankAmerica Corp. ($94 billion) and Citicorp ($90 billion).

14. Aggressive loss control efforts by insurers, and risk-sensitive premiums, coupled with the continuing growth in average bank size, should significantly reduce the

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insolvency loss percentages cited in footnote 5.

15. This is a very conservative (high) estimate, based on the following analysis. During the 1981-83 period, combined FDIC and depositor losses in commercial bank failures averaged about $245 million per year. The average insolvency loss in the 1981-83 period for all depository institutions would have been less than $400 million per year assuming (1) the insolvency rate loss in thrift and credit union failures would not have exceeded the loss rate in commercial bank failures and (2) thrift assets had already been marked to market values.

16. $120 billion of net worth divided by insolvency losses of $1 billion would give a cushion ratio of 120 to 1.

17. For 1983, American property/casualty insurers incurred losses and loss adjustment expenses of $87.2 billion. At the end of 1983, they had policyholder's surplus of $65.6 billion. $65.6 billion/$87.2 billion = .752. Data source: "Insurance Facts: 1984-85 Property/Casualty Fact Book," Insurance Information Institute (New York, 1984), inside front cover.

18. The Federal Reserve System turns over almost all of its substantial profits to the U. S. Treasury ($16.05 billion in 1984). These profits are then used for general governmental purposes. Any Fed insolvency losses, arising out of funds it advanced to a failing bank, would reduce, dollar-for-dollar, the Fed's contribution to the Treasury.

19. George Anders, "Money, Prestige Draw Wealthy Investors To Lloyd's of London Despite Big Risks," The Wall Street Journal, April 19, 1984, second front page.

20. In 1984, one out of every 183 U. S. commercial banks failed, the highest failure frequency rate since 1937. Over the five year period, 1980 to 1984, one commercial bank failed annually for every 412 operating banks. Roughly comparable ratios exist for S&Ls and credit unions.

21. Deposits in U.S. domiciled depositories exceeded $2.9 trillion at the end of 1984. $2,900,000,000,000 x .0001 = $290 million.

22. $300 million x 100 = $30 billion.

23. "The Canada Year Book," Dominion Bureau of Statistics (Ottawa, 1926 to 1936).

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APPENDIX B

4 April 9, 1985 American Banker

Comment

Structural Flaws Undermined Ohio Deposit Fund

Bad luck did not cause the collapse of the Ohio Deposit Guarantee Fund. The real reasons for the failure stemmed from structural flaws, according to consultant Bert Ely. The fund did not use the reinsurance mechanism to disperse its larger risk exposures and did not make proper arrangements for aid from the Fed in case of a run or liquidating payout. Also, the private deposit insurance industry has no system to collectively assume the liabilities of each failed insurer. Mr. Ely, a corporate financial consultant in Alexandria, Va., specializes in corporate insolvencies and deposit insurance studies.

By BERT ELY

FOR MANY, THE FAILURE of the Ohio Deposit Guarantee Fund, triggered by the failure of Home State Savings Bank, sounded the death knell for private, or nonfederal, deposit insurance.

Instead of burying private deposit insurance, however, it is important to examine the structural flaws contributing to the Ohio Deposit Guarantee Fund failure: 1) to determine how future private deposit insurer failures can be avoided, and 2) to strengthen private deposit insurance as an alternative to federal deposit insurance.

Apart from negligence or malfeasance, three structural flaws contributed to the fund's failure. These flaws are also present, to varying extents, in the 20 or so remaining private deposit insurers: five thrift insurers, 14 credit union insurers, and several industrial bank insurers.

The principal structural flaw: the Ohio Deposit Guarantee Fund did not function like a real insurer. Specifically, it failed to use the reinsurance mechanism to disperse its larger risk exposures, including Home State. By not reinsuring some portion of its Home State risk, the fund violated a basic insurance principle: Don't get wiped out by one major loss or a series of smaller losses.

Reinsurance is based on the well-founded fact that insurers survive by taking a large number of small gambles, including pieces of bigger gambles, rather than taking 100% of the big gambles.

Home State was a very big gamble for the fund, too big as it turned out. Home State, with assets of $1.4 billion, accounted for 25% of the assets of all the thrifts insured by the fund. Home State's insolvency loss, less than 15% of its asset value, wiped out its equity capital as well as the fund's reserve of $131 million. An insolvency loss arises when an institution's liabilities exceed the value of its assets.

The fund failed even though its reserves were approximately 2.9% of all the deposits it insured. This phenomenon demonstrates the fallacy of judging a deposit insurer's strength by measuring its reserves as a percentage of the total deposits it insures.. A more relevant measure of a deposit insurer's strength is the size distribution of its insured institutions and the relationship of the insurer's reserves to its larger risks. The last three deposit insurers to fail were sunk by their largest risks.

Reinsurance is based on the well-founded fact that insurers survive by taking a large number of small gambles, including pieces of bigger gambles, rather than taking 100% of the big gambles. Home State was a very big gamble for the Ohio Deposit Guarantee Fund.

The Ohio Deposit Guarantee Fund magnified its risk by tolerating, for several years, Home State's large, unsecured loans to E.S.M. Government Securities. When Home State failed, its net exposure to E.S.M. was $145 million, about 10 times Home State's regulatory net worth. Clearly, Home State, a risky proposition for any insurer, was doubly so for the fund.

While Home State's failure was inevitable, its insurer would not have failed under one of two circumstances: 1) the insurer had reinsured a substantial portion of its Home State risk with other insurers, 2) the insurer had substantially higher reserves than the fund.

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Liquidity Lacking

The second structural flaw: The Ohio Deposit Guarantee Fund had not made advanced arrangements to fund either a run on or a liquidating payout of one of its insured thrifts.

It is critical at this juncture to differentiate between bank runs and insolvency losses. Home State failed because $145 million in losses to E.S.M. made it insolvent, not because its depositors withdrew $154 million during a three-day run.

Bank runs per se do not create insolvency; they create illiquidity. If, however, that illiquidity forces a bank to sell assets at distressed prices to raise cash to pay deposit withdrawals, those forced asset sales will cause losses to the bank. Sooner or later, those losses will turn a solvent bank into an insolvent one. This is why so many sound banks failed during the 1930-1933 banking collapse.

When a lender of last resort (in the U.S., the Federal Reserve) advances funds to a bank experiencing a run, the lender is not assuming the bank's insolvency losses as it advances those monies. It merely becomes a substitute depositor with the bank. The act of funding a run does not alter the bank's solvency position one cent, provided its lender does not force it to sell assets at distressed prices.

Had the Ohio Deposit Guarantee Fund arranged to draw on the Fed as needed, it could have arrested any runs that might have occurred among its 72 insured institutions, including Home State. Ohio's mad scramble for cash after the Home State run started clearly indicates that the fund's standby liquidity arrangements, if there were any, were totally inadequate. Gov. Celeste would have had no excuse for closing the other thrifts insured by the fund if those arrangements had already been made.

Protecting Against Such Failures

The third structural flaw: The private deposit insurance industry does not have a mechanism for assuming the liabilities of a failed insurer. Instead, each deposit insurer stands on its own. If an insurer goes under without paying all its claims, depositors bear the losses not covered by the reserves of that insurer. In the last 10 years, depositors in six states have lost money, or the use of their money, because deposit insurers have failed or have not performed adequately.

A mechanism has been established by the property/casualty insurance industry whereby all insurers operating in a state absorb losses arising out of an insurance company failure in that state. While not without problems, this process does protect insured institutions and the public confidence placed in the surviving insurance companies.

The consequences of not having a backstopping mechanism for the Ohio Deposit Guarantee Fund are becoming increasingly obvious. Home State depositors almost certainly will suffer losses, as may depositors in the Ohio thrifts that will be liquidated because they do not qualify for Federal Savings and Loan Insurance Corp. insurance. Ohio taxpayers will also lose if the Ohio legislature uses tax funds to pick up some of the depositor losses. Private deposit insurers in other states will suffer as the institutions that they insure switch to federal insurance.

Strengthening the Private System

The private deposit insurers must take several steps to strengthen their industry.

Step one: Develop a marketplace for reinsuring large, individual deposit insurance risks, i.e., the bigger thrifts and credit unions. Since commercial reinsurers have shown little interest in this market, the deposit insurers will have to reinsure the risk among themselves. Spreading the larger risks over several insurers will also have a very salutary effect absent in the Home State and Ohio Deposit Guarantee Fund failures — several independent insurers will constantly monitor the very institutions most likely to cause an insurer to fail.

Step two: Create an industrywide standby liquidity facility that can handle the largest conceivable run or liquidating payout that might hit one of the private insurers. The Federal Reserve must be a key participant in that facility.

Step three: Protect depositors in institutions insured by a failing or financially strained private insurer. Reinsurance of the larger individual risks would go a long way toward lessening the likelihood of future deposit insurer failures; nonetheless, a process for backstopping a failed insurer must also be put in place.

The Ohio Deposit Guarantee Fund cannot be looked upon as a soundly managed but unlucky insurer. Rather, it failed in part because of very real structural flaws also present in the other private deposit insurers. Eliminate these flaws, and private deposit insurance will prosper as a permanent and viable alternative to federal deposit insurance. ■

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The CHAIRMAN. Thank you, Mr. Ely.
Mr. Filson.

STATEMENT OF CHARLES W. FILSON, SENIOR PARTNER, CALLAHAN & ASSOCIATES, WASHINGTON, DC; FORMER DIRECTOR, OFFICE OF PROGRAMS, NATIONAL CREDIT UNION ADMINISTRATION; IMMEDIATE PAST PRESIDENT, NCUA CENTRAL LIQUIDITY FACILITY

Mr. FILSON. Senator Garn, I have good news. Credit unions and their system of private and Federal share insurance are doing extraordinarily well. There are no major problems. But this result is not because the economy is well again, nor is it because credit unions were somehow immune from the recent recession and subsequent adjustments affecting many areas of the economy. A key factor why credit unions are leading in the deregulated market is because of a critical historical advantage developed in their system—private share insurance.

PRIVATE FUNDS INSURE 18 PERCENT OF CREDIT UNIONS

These 14 private funds insure 18 percent or approximately $18 billion of total credit union savings, in 3,100 credit unions. They provide State-chartered credit unions in 25 States a choice of insurer. That choice has been essential to maintaining a truly meaningful dual chartering system. Within the credit union system the leading examples of change and innovation have occurred at the State level. These include almost every important area of credit union activity including fields of membership, investment options, new delivery systems such as ATM's and credit cards, lending authority, and the most far reaching of all—deregulation of shares. These initiatives were possible under State law and regulation because they did not require the development of a national program or consensus.

During the recessionary years of 1979-82 credit unions were the most vulnerable of all the financial industries due to their dependence on a single sponsoring company or organization. From 1979 through 1981 shares of Federal credit unions grew at annual rates of 3.2, 9.9, and 4.2 percent respectively. The total growth of these 3 years is approximately equal to the outcome of any 1 year before or after this period.

The number of Federal credit unions reporting operating losses for the year ended 1980 was 3,950 or about 32 percent of Federal charters. The numbers and amounts of shares in problem code credit unions—that is, early warning system codes 4 and 5—insured by the National Credit Union Share Insurance Fund grew dramatically in these same years.

Given this background, it would not be an understatement to say that credit unions and their Federal insurance fund were on their back. But what happened? For the last 3½ years credit unions have reported record levels of share growth, ever higher earnings, rising levels of capital and fewer problem credit unions, fewer numbers with losses, virtually no industry liquidations, and steady declines in assisted mergers. The results are good and are still getting better.

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Why? Credit unions' dramatic turnaround was not due to some miraculous, all-encompassing solution, new operating powers, or any other external factor. Rather, credit unions made literally hundreds of adjustments in many different areas which responded to various problems and opportunities throughout the country. Added together, these multiple decisions created this success. The primary reason credit unions were able to initiate, experiment, and successfully carry out these changes was because of the flexible and responsive nature of the dual chartering system of supervision and regulation.

Perhaps the best illustration of this learning through others' experiences about how to respond to these pressures were the congressional changes enacted in July 1984 in the NCUA's insurance fund. All of the critical ideas in that bill came from the private insurance funds including: The 1-percent withdrawable capital deposit; the option of waiving the premium; the annual report with external CPA audit; and the payment of a dividend on the deposit.

Credit unions were willing to accept these radical approaches, never before tried at the Federal level, because these initiatives had been in place and working in the private credit union system.

Private credit union insurance does work. In the attached 1985 yearbook of the IS&DGA you will see statistics about these funds' performances. The reason for these results is partly structural and partly individual performance. The 14 private funds are closer to the action, have credit union representatives as active participants in their organizations, and have incentives to find the best solutions to problems.

The immediate question people raise is will the public accept private insurance? I would answer that federally managed and mandated insurance is required in no other areas of our life or commerce—not to insure our lives, our homes, our autos or even to a large extent our retirement funds. When periodic economic downturns occur, Federal insurance has become the excuse for trying to mandate Federal legislative or regulatory solutions to marketplace challenges. We take this approach in no other area of our economy. Federal insurance instead of a last resort safety net, or of one option among several, becomes the principal factor controlling the major business decisions for thousands of financial organizations.

I would make a recommendation: Extend options. If private insurance works for State-chartered credit unions, why not give Federal credit unions the choice as well? I think options are essential for maintaining a responsive Federal system. For the choices opened in a dual chartering system are critical to every credit union's well-being—whether federally or State chartered. Private insurance funds make dual chartering a reality and in doing that give all credit unions a more responsive system of regulation and insurance.

Thank you for this opportunity.

[The complete prepared statement follows:]

TESTIMONY OF CHARLES W. FILSON ON BEHALF OF INTERNATIONAL SHARE AND DEPOSIT GUARANTY ASSOCIATION

Senator Garn and members of the Committee: Thank you for the opportunity to discuss credit unions and their share insurance. I have good news. Credit unions and their system of private and federal share insurance are doing extraordinarily well. There are no major problems. In fact all the positive indicators of economic success -- growth, earnings, capital levels, membership expansion -- are setting records.

The Critical Credit Union Advantage

But this result is not because the economy is well again nor is it because credit unions were somehow immune from the recent recession and subsequent adjustments affecting many areas of the economy. Indeed the deregulation of the financial services industry is possibly causing more fundamental change for these institutions than in any other sector of the economy. Credit unions are at the forefront of this change. A key contributing factor why they are leading this evolution and succeeding so well is because of a critical historical advantage developed in their system -- private share insurance.

Hopefully by describing how this has occurred, there may be a contribution to some of the issues discussed before this committee by representatives of the banking and S&L industries.

Eight Years of Credit Union Insurance Responsibility

My involvement with credit union insurance goes back to 1977 when I was appointed Supervisor of Credit Unions in Illinois. Of the approximately 1,300 state chartered credit unions under our supervision at that time only 25% had insurance and that was from the National Credit Union Administration (NCUA). The following year a mandatory insurance bill was passed by the legislature which gave Illinois credit unions only one option -- NCUA. Because of our supervisory experience and the preference of Illinois credit unions, we believe an insurance option was vital to the future of the state chartered system. Working with Illinois credit unions, the Illinois Credit Union League and the Governor's Credit Union Advisory Board we were able to change the law to give Illinois chartered credit unions the option of either private or federal share insurance. We invited all private insurers to make application under this law and subsequently approved the only one to do so. Today, the largest privately insured credit union, over $850 million in size, is in Illinois -- United Airlines Employees Credit Union.

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In December 1981, I joined NCUA to continue working with Ed Callahan, the former Illinois regulator, who had been appointed Chairman. One of my responsibilities for the next three and half years was supervision of the National Credit Union Share Insurance Fund (NCUSIF). During that time NCUA was an active member of the association of credit union insurers called International Share and Deposit Guaranty Association (IS&DGA). We joined this Association to share experiences and methods about our common responsibility to credit union members. Moreover these private funds had much stronger reserves and better loss control results then the NCUSIF had yet achieved. We drew extensively upon the experience of these private funds in trying to restructure the NCUSIF from what was perhaps the weakest of all savings insurers to one that recently achieved an unqualified-opinion, in accordance with generally accepted accounting principles, from a Big 8 accounting firm -- a first among federal insurers.

A critical event in our management and search for better ways of carrying out our responsibilities was the study you requested of deposit insurance in the Garn/St Germain bill passed on November 15, 1982. From that study came the seeds that resulted in the unprecedented federal legislation passed in July, 1984 to capitalize the NCUSIF. That action, as Senator Garn stated in the announcement of these hearings, is why the NCUSIF is not on the Committees agenda for possible change.

The NCUSIF legislation by itself could have put new competitive pressures on the private funds independent of the problems that occurred in the state sponsored S&L insurers in Ohio and Maryland. Therefore, while at NCUA we initiated efforts (see appendix A) to minimize any undesirable side effects and to support the continued successful workings of the private credit union insurers. We did this because we strongly believe that they are very key to a successful and responsive credit union regulatory system. Upon leaving NCUA we had the opportunity to continue this work with private insurers through the management of IS&DGA. In that responsibility we are working to help those funds regain the momentum and credibility within the credit union community which recent events have challenged.

Essential Role of Private Insurers

During this eight years of involvement with private and NCUA credit union insurance, I became convinced that private insurers are a critical component of credit union success. They insure 18% or approximately $18 billion of total credit union savings, in 3,100 credit unions. They provide state chartered credit unions in 25 states a choice of insurer. That choice has been essential to maintaining a truly meaningful dual chartering system. Within the credit union system the leading examples of

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change and innovation have occurred at the state level. These changes include every important area of credit union activity including fields of membership, investment options, new delivery systems such as credit cards and ATM's, lending authority, and the most far reaching of all -- deregulation of shares. Total deregulation of shares which occurred at NCUA in April 1982 for federal credit unions, had been a reality in over a dozen states including Illinois, for years prior to NCUA's actions. These examples of successful changes in local areas in response to new circumstances were seen and slowly adopted at the national level as the new services and options proved successful. And many of these changes occurred because of the flexibility given state supervisors by a system of private share insurance. These initiatives were possible under state law and regulation because they did not depend on the development of a national consensus or program.

Credit Unions Severely Affected by Economic Downturn

To understand what this has meant to all credit unions, both state and federal, and to the well-being of their financial system one has only to look at the pressures faced by credit unions during the recessionary years of 1979-82. Credit unions were the most vulnerable of all the financial industries due to their dependence on a single sponsoring company or organization. It was unusual to find a business that did not suffer a downturn in these years. Some of the major industries where credit unions were deeply involved such as auto, steel, textiles, and natural resources were severely affected.

These pressures showed up directly in the economic results reported by credit unions. From 1979 through 1981 shares of federal credit unions grew at an annual rates of 3.2%, 9.9% and 4.2% respectively. The total growth of these three years is approximately equal to the outcome of any one year before or after this period. This is the only time in credit union history of which I am aware that there were three consecutive years of single digit savings growth.

The problems were deeper than a lack of growth however. For example the number of federal credit unions reporting operating losses for the year ended 1980 was 3,950 or about 32% of federal charters. This was an increase from 22.2% or 2,825 in 1979. The total of losses in 1980 of over $120 million were double those of 1979. (Source: NCUA 1982 Annual Report, pg. 24)

The numbers and amount of shares in problem code credit unions (codes 4 and 5) insured by the NCUSIF grew dramatically in these years:

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	Number of Credit Unions	Shares in Millions	% of Total Insured Shares
1978	825	$ 1,450	3.3%
1979	1,020	2,300	4.8%
1980	1,018	2,400	4.4%
1981	1,174	2,980	5.2%
1982	1,192	4,590	6.7%
1983	1,124	4,652	5.8%

(Source: NCUSIF 1984 Annual Report, pg. 51)

The number of liquidations, mergers, non-cash guaranty accounts and other forms of assistance grew at ever increasing rates.

	1978	1979	1980	1981	1982	1983
Mergers	196	193	313	333	439	706
Liquidations: a) Number	168	169	239	251	160	50
b) Shares in Millions	$14.2	$19.0	$60.0	$78.6	$39.9	$9.9
Contingent Liabilities as a % of Fund Equity	8.6%	12.4%	60.7%	98.2%	83.8%	29.7%

(Source: NCUSIF 1984 Annual Report, pg. 49)

Given this background, it would not be an understatement to say that credit unions and their federal insurance fund were on their back. This was a time of serious economic strain and as if this were not enough, deregulation was bringing new players, new challenges and new pressures.

What happened? If I stopped the story at this point you might think that this was the final chapter of an interesting but now failing experiment in cooperative financial ownership.

Three and One-Half Years of New Levels of Record Performance

No, just the opposite. For the last three and one half years credit unions have reported record levels of share growth, ever higher earnings, raised levels of capital and fewer and fewer problem credit unions, fewer numbers with losses, virtually no industry liquidations, and very few assisted mergers. The results are good and still getting better. Some of these statistics are:

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	Annual Share Growth	Annual Net Income Increase	% CU's Reporting Losses
1982	17.3%	11.4%	22.1%
1983	20.7%	17.6%	22.3%
1984	16.1%	65.9%	9.9%
1985 (6 months)	18-20% (est.)	N/A	N/A

(Source: NCUA 1984 Annual Report, pgs. 29, 37)

Today, average total capital is 6.3% (December, 1984) and rising. Capital growth exceeds the extraordinary rate of double digit share growth. The quality of credit union assets as measured by loan delinquency, loss allowance levels, and the maturity structure of investments is steadily improving.

In sum an industry that was in deep distress from 1979 through 1981 is reporting constantly better financial results across the board month after month.

How were Successes Achieved

Why? How could this industry which was so severely threatened and weakened make such an extraordinary turnaround? Was it the economic recovery? Hardly. For there are still major economic problems in certain sections of the economy. Is it because the financial services industry has recovered so well -- one has only to read of record losses at specific banks, continuing structural problems with S&Ls, post depression records in bank liquidations, new leadership at insurance companies, and the bankruptcy two years ago of a major financial conglomerate to know that the state of the industry is still unsettled and uncertain. That's one of the reasons for these hearings.

Credit unions' dramatic turn around was not due to some miraculous, all-encompassing solution, new operating powers, or any other external factor. Rather credit unions made literally hundreds of adjustments in many different areas which responded to various problems and opportunities throughout the country. Added together, these multiple decisions created this success. And the primary reason credit unions were able to initiate, experiment and carry out these changes successfully was because of the flexible and responsive nature of the dual chartering system of supervision and regulation.

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Federal Fund Beneficiary of Change

Perhaps the best illustration of this learning through others' experiences about how to respond to these pressures were the changes made in the NCUA's insurance fund (NCUSIF). For not only were credit unions in dire economic circumstances in the early 1980's, so was their federal insurance fund. Fund equity to insured shares was the weakest of all insurance funds and declining:

	Fund Equity as a % of Insured Shares
1979	.320%
1980	.303%
1981	.302%
1982	.259%
1983	.292%

(Source: NCUSIF 1984 Annual Report, pg. 49)

Fund net earnings were at all-time lows in both dollar amounts and as a percentage of income. For example in 1982 after a second premium assessment of over $29 million the Fund was able to add $3.1 million to equity or just 3.3% of gross income. The "normal" level of addition to equity before these traumatic years was in excess of 70% of gross income. (Source: NCUSIF 1984 Annual Report, pgs. 48-49).

Fund earnings were low because expenses were high due to assisted mergers, liquidations and the other forms of assistance outlined above. Another special premium in 1983 and the prospect of continuing double assessments far into the future caused credit unions to seek a better way to structure their fund. The Garn/St Germain study was submitted in April of 1983 and from that effort came the ideas that resulted in a new NCUSIF insurance law enacted in July 1984.

Private Funds Help Federal

All of the critical ideas in that bill came from the private insurance funds. Those include:

- The one percent withdrawable capital deposit;
- The option of waiving the premium;
- The annual report with external audit;
- The payment of a dividend on the deposit.

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Credit unions were willing to accept these "radical" approaches never before tried at the federal level because these initiatives had been in place and working in the private credit union system. These ideas weren't theory, rather they had been subject to the test of the marketplace and found to be very practical. For example throughout the 1979-1984 economic cycle the private credit union funds had gained over $1.1 billion in savings from credit unions which voluntarily changed from the federal insurance system.

Private Funds Predate NCUSIF

Credit unions operated without share insurance for most of their history. Federal credit unions successfully grew and had no share insurance for 36 years and some state charters for even a longer period. The credit union experience with private credit union insurance goes back ten years prior to the formation of the NCUSIF. Share insurance began in Massachusetts in 1961. This and other private funds were part of the precedents contributing to the support for a federal insurance option culminating in the passage of the NCUSIF legislation in 1970.

Private credit union insurance works. Because it works the credit unions today have the only real dual chartering financial system. That system gives credit unions choices and options and the ability to be responsive, experimental and innovative. The result is a movement that leads change and is not a prisoner to it.

Private Funds Outperform Federal

When I say private credit union insurance works it is important to be specific about how and why. In the attached 1985 IS&DGA Yearbook you will see statistics about these funds' performances. A most important comparison is the history of losses. Private funds have an extraordinarily better record than does the NCUSIF. (See pages 7-8 IS&DGA 1985 Yearbook) The ratio of their collective reserves to recent losses is more than two and one half times nigher than the NCUSIF's.

The reason for this result is partly structural and partly individual performance. The fourteen private funds are closer to the action, have credit union representatives as active participants in their organizations, and have incentives to find the best solutions to problems. Also, the private funds know their performance must be better to compete with the federal image and federal economies of scale.

On the other hand a federally-managed fund must treat credit unions very much alike, in a homogenous manner, from

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Hawaii to Maine, from Florida to Montana. A national organization finds it difficult to be responsive to local conditions and needs. By their very nature a government organization must mandate or follow a broad, uniform approach, usually entitled programs or policies, to problem solving. For example the NCUSIF is approving over 50 mergers a month; the fourteen private funds combined rarely total that in a year. Therefore each merger situation for a private fund can receive a much closer, hands-on approach than circumstances would allow for NCUA's fund.

Implications For Other Financial Industries

What are the implications of this example for this Committee's concerns? What does the private credit union share insurance experience suggest for public policy? You have heard much discussion and debate about specific issues related to the banking and S&L industries. Should minimum capital levels be set at 9% or 5.5%? Should premiums be risk-rated? Should examinations efforts focus more on off-site computer review or on-site examiner contact? Should the Fed be a more willing lender in liquidity runs? Should the FDIC and FSLIC be merged? And so on. I don't believe, based upon my eight years of experience as a state and then national regulator, that there is or ever will be a single right answer or solution to any of these issues.

To try to mandate or seek a uniform national solution or approach to these concerns and issues will only lead to the lowest common denominator kind of outcome. Some would even argue that to continue to seek a uniform federally imposed solution will just repeat the process by which the problems were exacerbated, if not created, in the first place.

The solution is not for new regulations with greater detail about critical areas of economic judgment. The solution is to open up options, to encourage multiple approaches by regulators and insurers. The key to this flexibility in the credit union system is a private insurance option.

Will Public Accept Private Insurance

The immediate question people raise is will the public accept it? I would answer that federally managed and mandated insurance is required in no other areas of our life or commerce -- not to insure our lives, our homes, our autos or even our retirement funds (to a large extent). Federal insurance of savings began as a response to the unique economic events of the great depression. When those events no longer were present, insurance did not go away, it stayed on. Now when periodic economic adjustments occur federal insurance has become the excuse for trying to mandate federal legislative or

regulatory solutions to marketplace challenges. We take this approach in no other area of our economy. Federal insurance instead of a last resort safety net, or of one option among several, becomes the principal factor controlling the major business decisions for thousands of financial organizations. And the results are the dilemmas discussed earlier in these hearings. The credit union example suggests there is another way . There is an opportunity for choice, innovation and flexibility.

Recommendations For Action

What can be done to support this alternative? Let me suggest two things:

One, extend options. If private insurance works for state chartered credit unions why not give federal credit unions the choice as well. Anytime one economic choice is legally restricted in the face of a successful private alternative, the member/consumer will lose. Let people decide which insurance they want. The federal regulator, NCUA, in the study submitted to Congress on April 15, 1973 made that the first recommendation.

I think options are critical for maintaining a responsive federal system. For the real choices opened by a dual chartering system are essential to every credit union's well-being -- whether federally or state chartered. Private insurance funds make dual chartering a reality and in doing that, give all credit unions a more responsive system of regulation and insurance.

Secondly, efforts like this Committee's current hearings to describe the important role and the record of private insurance need to be encouraged. Statements made about the future of insurance as well as legislative or administrative decisions in the midst of a dramatic public crisis may not be sufficiently thought out in terms of their long term implications. Shifting all savings insurance issues onto the federal "plate" as several states have recently done dramatically reduces those state's ability to help their citizens respond to future needs or concerns where financial institutions involved. Similarly I believe the dramatic restructuring of the NCUSIF was possible because credit unions were not confronted with crisis and were able to examine and explore issues in a thorough manner. The open and considered conduct of these hearings to explore private fund's role in savings insurance is very positive. It is essential that the support of options be both a federal and a state concern.

Thank you for this opportunity. I will answer any questions the Committee may have.

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Reported by CU Magazine's Washington Desk

Could the NCUSIF jeopardize private funds?

WITH THE CAPITALIZATION of the National Credit Union Share Insurance Fund (NCUSIF) virtually complete, credit union policymakers in Washington are beginning to ponder some of the long-range implications of the capitalization plan. Their concern, in a nutshell, is that a stronger, more efficiently managed and cost-effective NCUSIF could eventually put many of the private insurers under heavy competitive market pressure. This pressure, when combined with growing public anxiety over the stability of deposit-insurance funds generally, could jeopardize the dual -- federal and private -- deposit-protection system that credit unions now enjoy and, perhaps, force some private insurers out of business.

"No," says Tom Gaines

THE PRIVATE INSURERS DON'T ALL SHARE THIS CONCERN. Says Tom Gaines, president of the State Credit Union Share Insurance Corporation: "I don't think capitalization necessarily gave NCUA a leg up on the private insurers. The changes the agency made will promote healthy competition, and that's good for everyone. But the competition in the long term will be about consistency of performance, not about one change of product or pricing. And we're constantly going to have to be adjusting, not to one another, but to the demands of the credit union consumer."

NCUA believes in dual deposit protection

FEDERAL CREDIT UNION REGULATORS, for their part, believe that a strong group of private insurers is a vital industry resource and one well worth preserving, not only for its accomplishments but also for its future contributions. Indeed, they view private insurers as an essential check and spur to the federal insurance fund. Says NCUA Director of Programs Chip Filson, "The NCUSIF is where it is today because the private funds showed what could be done. Without them to take the lead, the NCUSIF could stagnate, and credit unions would be left without a viable insurance alternative."

Private funds insure about 40% of state CUs

CURRENTLY, THERE ARE 15 PRIVATE SHARE GUARANTY CORPORATIONS. Collectively, they insure $15.5 billion in credit union deposits, or about 17% of total credit union savings. Although several private funds were established before Congress created the NCUSIF in 1970, most were formed in the early or mid-1970s, when state governments began to require their state-chartered credit unions to purchase deposit insurance. For many reasons, including skepticism toward federal government involvement in their affairs, many state-chartered credit unions opted for private protection. Now nearly 40% of state-chartered credit unions are covered by private guarantors.

ARE THERE REASONS TO THINK the market share of private insurers might change significantly? Federal regulators think possibly yes. They note that the last two and a half years have been tumultuous for the deposit-insurance field, beginning with the collapse of Penn Square National Bank in 1982 and continuing with the near collapse of Continental Illinois and the

CAPITAL EVENTS

Financial Corporation of America. These events have highlighted basic flaws in the deposit-insurance system and raised public concerns about the ability of insurers to protect depositors in failing institutions.

Deposit insurance reform at issue

DEPOSIT-INSURANCE REFORM has become a leading banking issue in Washington. The Federal Home Loan Bank Board recently asked Congress to give it authority to collect as much as an additional $10 billion from the troubled savings and loan industry to shore up its shrinking insurance fund. The Vice-Presidential Task Group on Regulation of Financial Services included a chapter on deposit reform in its study of the federal financial regulatory system, the Bush Report. The General Accounting Office, too, has been asked by Congress to study deposit insurance. Almost certainly these studies will recommend legislation, and whatever proposals are adopted by Congress will likely be considered by state governments, especially if a major private insurer should fail in the near future. Some rumblings have already occurred. Recently, for example, the Nebraska Depository Institution Guaranty Corporation went under and the Thrift Guaranty Corporation of California suffered a setback when an industrial loan company it insured went bankrupt.

Attention is on banks and S&Ls

FORTUNATELY FOR CREDIT UNIONS, most of the attention being paid to deposit insurance has focused on banks and savings and loans and their insurers. Among the reasons for this benign neglect is that NCUA has moved to strengthen the NCUSIF. The agency has reduced the fund's insurance losses and controlled its operating expenses. It has succeeded in getting legislation enacted ensuring the fund's tax-exempt status and implementing the capitalization program.

IF THE CAPITALIZATION PROGRAM DEVELOPS AS ADVERTISED, and if NCUSIF administrators can continue to waive the annual insurance premium and return a decent dividend to credit unions on their 1% deposit, private funds will be under competitive pressure to offer a comparable insurance package to retain their market share. Some will be able to meet this challenge. Some may not, prompting NCUA to worry that if any share guarantor suffers major financial difficulties, the entire group may be endangered either by lack of public confidence or by legislation mandating blanket federal insurance.

NCUA offers private funds a CLF credit line

TO PREVENT THIS DISMAL SCENARIO FROM UNFOLDING, NCUA policymakers would like to see the private share insurers take the opportunity afforded them by the current strength of credit unions and the NCUSIF, and congressional satisfaction with the state of the movement, to position themselves for the future. One idea they have suggested is that the private guarantors consider banding together to negotiate a lending arrangement with the agency's Central Liquidity Facility. Essentially, the CLF would make a low-cost pool of credit available to the private funds in the event any fund should not have ample cash to pay off depositors. The CLF loan would be collateralized by both the assets of the failed credit union causing the liquidity need and the combined reserves of the share insurers.

THIS PROPOSAL IS CURRENTLY BEING GIVEN A HARD LOOK by a committee made up of members of the International Share and Deposit Guaranty Association, a private insurers' trade group. How the group responds may prove to be pivotal for credit unions and their insurers in the years ahead. The organization may accept NCUA's plan or come up with counterproposals of its own. On the other hand, the private funds may feel sufficiently confident of their management and marketing skills to hold their own in the marketplace without altering the status quo.

Brooke Shearer
Washington Correspondent
Credit Union Magazine

[redacted]

International Share & Deposit Guaranty Association

The Organization of Cooperative Credit Union Insurers

1985 YEARBOOK

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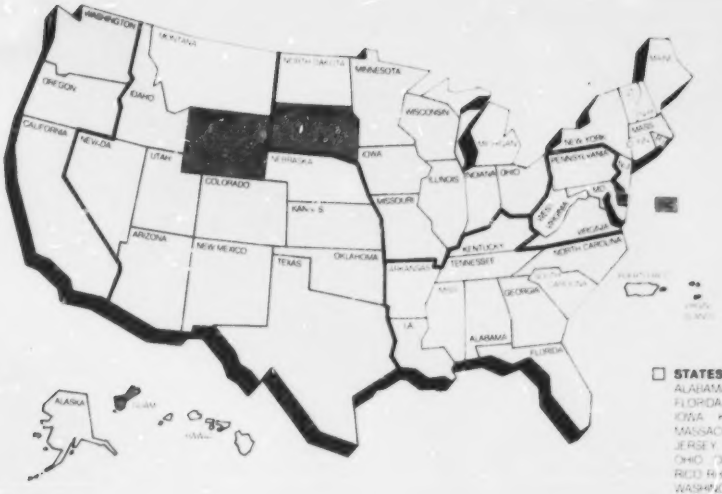
INSURANCE OPTION STATES



☐ **STATES WHICH HAVE INSURANCE OPTIONS** – ALABAMA, ALASKA, ARIZONA, CALIFORNIA, COLORADO, FLORIDA, GEORGIA, HAWAII, IDAHO, ILLINOIS, INDIANA, IOWA, KANSAS, KENTUCKY, LOUISIANA, MARYLAND, MASSACHUSETTS, MINNESOTA, MISSOURI, NEVADA, NEW JERSEY, NEW MEXICO, NEW YORK, NORTH CAROLINA, OHIO, OKLAHOMA, OREGON, PENNSYLVANIA, PUERTO RICO, RHODE ISLAND, TENNESSEE, TEXAS, UTAH, VIRGINIA, WASHINGTON, WEST VIRGINIA, WISCONSIN.

☐ **MANDATORY NCUSIF INSURANCE** – ARKANSAS, CONNECTICUT, MAINE, MICHIGAN, MISSISSIPPI, MONTANA, NEBRASKA, NEW HAMPSHIRE, NORTH DAKOTA, SOUTH CAROLINA, VERMONT.

☑ **NO STATE CREDIT UNIONS**—DELAWARE, D.C., GUAM, SOUTH DAKOTA, VIRGIN ISLANDS, WYOMING.

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The Chairman's Review

The events of the past twelve months have highlighted the challenges of credit unions and their insurance system more than any of us could have ever anticipated. For the 14 members of the International Share and Deposit Guaranty Association and their 3,100 credit unions, the movement on has changed dramatically.

Throughout 1984 the concerted drive credit union insurers continued a two- and one-half year explanation effort that now over $11.3 billion of state-chartered credit union savings switch from federal to private funds. Partly in response to this pressure and partly due to concern that the public would perceive that NCUA Share Insurance Fund (NCUSIF) as the weakest of all federal insurers, NCUA introduced legislation that capped the financial structure of the private funds. This effort, which quadrupled the capital base of the NCUSIF, was completed in January of 1985 with predictions of a positive dividend. This event by itself would have created a very different competitive relationship than that had recently existed with NCUA. Then the crisis in Ohio, and Maryland, among state chartered savings and loan insurance corporations added a new extreme threat and a needed promotion activity concerning the credibility of any private insurance fund.

One result has been a swing of the pendulum back in the direction of federal insurance. However, another concern has been the issues raised not just by external commentators, but by some in the credit union community, as to whether the movement should even exist, should these savings in effect seeking private insurance still provide, ultimately for credit unions and their members. We believe the articles in this *Yearbook* will answer that question by showing the historical philosophical and real bottom line advantages of private insurance. Not only was credit union insurance first offered by a private fund in 1961, but also almost all of the major credit union innovations in field of membership, delivery of services, new product introduction, investment options, and many other areas of operation have been developed in the state chartered, privately insured system. These advantages tested and found workable on a local level, then spread across the credit union community to be accepted as the norm. The most dramatic example of this real strength is state deregulation which was tried, accepted, and successfully in more than a dozen states prior to comparable action by NCUA in 1982 for federal credit unions.

Credit unions' uniqueness has been their ability to change in response to the needs of their members in the many different markets throughout the country, from the community based credit unions of New England, to the industrial and occupational groups of the mid-west, to the high tech companies in California and the senior citizen and retiree communities of the sunbelt states. The result has been a competitively strong system that is growing faster and is far stronger by almost any measure of analysis than competing financial systems. Private share insurance has been a keystone in this credit union success by providing the only meaningful dual chartering system. This system has fostered innovation and creativity, and has given the chartering authorities that prevent one regulatory institution's view—whether state or federal—from being imposed on a rapidly changing marketplace.

And the economic advantage of private insurance, as discussed in the following articles is that credit unions have created not just a more responsive insurance system, but a more *cost effective* one through the combined efforts of the IS&DGA members.

There is no question however that the challenges of the present are greater than any of the recent past. Standing on our record of action our philosophy is not enough to meet our commitments to the continuing success of credit unions. IS&DGA, created in 1974, is valorizing its organization. In May the Board voted to hire the newly formed credit union consulting firm of Callahan & Associates to coordinate these efforts. Senator Edward F. Callahan is the former state regulator in Illinois and from 1981 to 1985 was the NCUA Board Chairman. In the interview that begins on page 10, Mr. Callahan reaffirms the historical contributions and continuing advantages of private insurance.

But IS&DGA members are doing more than protection. We are continuing to refine our insurance tools to help credit union managers better compete in a deregulated marketplace. Our goal for the next year is to bring a new level of insurance protection and assistance so that private insurance continues to be at the leading edge of credit union successes. We are excited by the opportunities on our horizon and hope this *Yearbook* will be just the first chapter in a new era of unique accomplishments.

John Martin
Chairman, IS&DGA
July 22, 1985

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(See pages 15-16)

PRIVATE INSURANCE: THE CREDIT UNION ADVANTAGE

by Catherine England

Catherine England is a senior economic policy analyst with the Cato Institute, based in Washington, D.C., where she is also assistant editor of the Cato Journal. Miss England has an M.S. in economics from Texas A & M University, and expects to receive her Ph.D. from there later this year. She has written extensively in the area of banking regulation and deposit insurance, including recently published articles in the Wall Street Journal and Consumers' Research Magazine. She is also the author of Banking and Monetary Reform, recently published by The Heritage Foundation.

No one could have foreseen when 1985 began the events that would direct public attention to private deposit insurers and the institutions they serve. In March, the savings and loan crisis in Ohio was widely portrayed as a "failure of private deposit insurance," and even though no credit unions were insured by the Ohio Deposit Guarantee Fund, depositors suddenly became more aware of those signs in the window advertising the source of share guarantees. As if that were not enough, the Ohio crisis was followed in May by the S&L episode in Maryland. While less dramatic, the problems encountered by the Maryland Savings Share Insurance Corporation intensified the interest in non-federal deposit insurance. Local television stations sent news crews out to unearth privately insured institutions, and consumers' advocates urged individuals to consider carefully before putting their hard earned money into non-federally insured institutions of any kind.

Politicians have also predictably joined the bandwagon to call for mandatory universal federal insurance. Several state legislators and their governors, eager to avoid even the hint of problems similar to those in Ohio and Maryland, are considering requirements that would force all deposit-taking institutions to obtain federal insurance. State banking supervisors in some states are making public their preference for federal guarantees, even though no legal directive exists, thus attempting to use private and public pressure to encourage privately insured credit unions and savings and loans to apply for federal coverage. And in Washington, several bills have been introduced in Congress that would compel all depositories to obtain their insurance from one of the three federal funds.

It seems to be rapidly becoming the conventional wisdom to support federal insurance. "Why should depositors risk their savings in privately insured institutions if federal guarantees are available and comparably priced?" experts ask. And many depositors may wonder the same thing. As Jim Blaine, president of the North Carolina State Employees Credit Union, a privately insured institution that recently applied for federal insurance when its private guarantor elected to dissolve, pointed out in a recent interview, "The federal system allows the depositor to be lazy. The public perception is that federal is safer."

MORE THAN CHOOSING CAR INSURANCE

But the choice involved is not as simple and straightforward as, say, choosing or changing car insurance. The issue at hand is much more far reaching and, ultimately, raises fundamental questions about who will make long-run decisions about the future directions of the credit union movement and the role it will play in tomorrow's economy. Credit unions and their members, in deciding whether to fight to maintain the current dual system of share insurance or to acquiesce to political pressures calling for a federal monopoly, are really deciding whether regulatory control of the industry will remain largely decentralized with the states continuing to play important roles or the National Credit Union Administration will be allowed to take the dominant part in regulating credit union activity.

"The insurer is a regulator. With a monopoly insurer, dual chartering becomes a sham."

While often lumped with other depository institutions in texts and news stories, the nation's credit unions have a very different history. As Robert A. Sorin, Ohio Superintendent of Consumer Finance, noted in a recent interview, "My opinion, and that is after having worked through hundreds of financial statements, is that credit unions are inherently different from savings and loans."

Their cooperative nature and emphasis on people, not profit, have always set these institutions apart from other depositories. Members tend to know each other because they often work together or live in the same community. Hence, from 1909, when the first credit union was established, until 1961, when the Massachusetts Credit Union Share Insurance Corporation was founded, credit unions not only managed to attract and hold funds without any deposit insurance, they thrived. And it was not until 1970, more than 35 years after the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC) were established, that Congress made federal insurance available to credit unions.

Currently, there are 14 private insurance funds offering deposit guarantees to credit unions in 25 states and Puerto Rico, and the credit union industry has avoided shocks similar to those experienced of late by the thrift industry. Thus, credit unions are set apart not only by the nature of their business but also by the fact that they have almost a quarter century's experience with a private share insurance system that has worked.

PRIVATE INSURANCE PREDATES FEDERAL

In fact, it was at least in part the development of private guarantors that led Congress to "reward" the credit union industry with a federal insurer of its own. The National Credit Union Share Insurance Fund (NCUSIF) was established in 1970, making it by far the youngest of the federal insurance funds. And, because it was never loaned capital by the federal government as were the FDIC and FSLIC, the NCUSIF in the early 1980's found itself the weakest of the three federal funds. To strengthen its reserves, the NCUSIF recently changed its whole approach to building the fund's capital base. And what was the model used for revitalizing the NCUSIF? Rather than looking to the other federal insurers, National Credit Union Administration officials turned to private share insurers to discover what had worked in the credit union industry.

Because private insurance historically has played a much larger role in the credit union industry than for savings and loans—insuring 18% of all credit union savings—the advantages of such a system are more obvious among credit unions than among other depositories.

Chief among these advantages is the diversity that marks the credit union industry. Among credit unions there remains a truly dual system of chartering, and that choice is a direct result of the widespread existence of private share guarantees for credit unions.

INSURER IS A REGULATOR

As Ed Callahan, Chairman of the National Credit Union Administration until May 1985 and now a senior partner of Callahan and Associates, has pointed out, "The insurer is a regulator. The credit union system is working well today because there is a balance between state and federal insurers and regulators. Credit unions have a viable option. With a monopoly insurer, dual chartering becomes a sham." While minor distinctions may exist between state and national bank charters, for example, all important regulatory decisions for banks are made in Washington. Congress and the federal regulators justify their control over all banks by noting the role the federal government plays in guaranteeing almost all bank deposits.

"Unforeseen events could turn federal regulations into a hangman's noose."

But what's wrong with the central control of an industry? Why should credit union managers and members be wary of federally mandated homogeneity?

First, no one can foresee how changing economic and technological conditions will affect the markets and competitive status of credit unions. Thus, the ultimate keys to survival require an ability to adapt to changing conditions and to diversify one's earning assets.

State legislators and regulators are generally faster to adapt to rapidly changing conditions by removing or modifying excessively binding regulations than their federal counterparts. As Gene Artemenko, president of United Airlines Credit Union, recently noted, "Statutory changes, regardless of how well justified, are much more difficult to enact at the federal level because there are 435 Representatives and 100 Senators deciding whether a particular law should be changed, and the American Bankers Association, the savings and loans, as well as others all get into the act and try to control what happens to you." With private share insurance and state regulation, Artemenko says, "We find there is much more flexibility because we're much closer to the regulators."

"You can't have logic when you're dealing with 18,000 credit unions."

DIVERSITY PROTECTS THE INDUSTRY

In addition, extensive federal control of any industry carries with it serious risks if subsequent events prove a particular regulatory decision wrong. For example, a large part of the thrift industry's problems can be explained by federal policies requiring all S&Ls to invest the lion's share of their assets in long-term, low interest, fixed-rate home mortgages. Neither individual institutions nor the industry was able to diversify and, as a result, the industry (and, hence, its federal insurance fund) is in dire straits. Similarly, if virtually all credit unions become subject to federal regulation, the entire industry will be affected if unforeseen technological or economic events turn federal regulations designed as a safety net into a hangman's noose. Diversity among regulators, therefore, is a means of protecting the industry.

Beyond these "safety and soundness" and "good of the industry" arguments for maintaining a dual system of regulation and insurance, there are significant advantages to individual credit unions—whether federally or privately insured and regulated.

Gene Artemenko, in explaining why his credit union is committed to the idea of private guarantees, notes that, "If you do what everyone else does, 'ordinary' becomes the standard."

FEDS SAY "NO" TO NOW ACCOUNTS

Robert F. Bianchini, President of the Rhode Island Credit Union League, cites federal inflexibility as the very reason Rhode Island has a private share insurer. The Rhode Island Share and Deposit Indemnity Corporation was established because the National Credit Union Administration refused to provide federal insurance to Rhode Island-chartered institutions providing checking accounts to their members. Rhode Island regulators, foreshadowing future trends in the financial services sector, had okayed checking accounts for credit unions while federal regulators had not yet recognized which direction the market would take. Bianchini notes that Rhode Island credit unions have since had reason to "thank our lucky stars that incident took place and a private insurance fund was formed."

Marvin Umholtz, Vice President of the Kansas Credit Union League adds, "I think local control is one reason why members opted for the right to use either [federal or state] insurance; maybe they think the Kansas legislators will be more understanding of their problems than the Congress."

Additionally, Bianchini points out that federal authorities

cannot always react with the same sensitivity as a private insurer. He cites examples of several strong credit unions operating in Rhode Island today that would not be around if it were not for private insurance. At various points in their history, these credit unions ran into serious problems, but, Bianchini notes, "The personal attention, the local presence of the Rhode Island share insurer, was paramount to providing solutions to those problems. Federal insurers would have been unable to deal with problems on as personal a basis because of the sheer numbers with which they have to deal. These institutions would have been simply merged or liquidated rather than being nursed back to health."

"Private insurers can facilitate deregulation."

The private system benefits federal credit unions as well. For instance, it allows Art DeFusso, President of the Eastern Airlines Federal Credit Union, to offer his members insurance on every dime of their deposits, including those exceeding $100,000, by using private insurance as a supplement to his federal guarantees. Similar options are largely unavailable to other depositories, and without an active system of private insurance, funds would be unavailable to credit union members. Federal law prohibits any federal insurance fund from offering insurance that exceeds $100,000 unless the two other funds also expand their coverage.

CHOICE BENEFITS CONSUMERS

Federal and state officials agree it's good to have a choice. JoAnn Ewalt, a spokeswoman for the NCUA, responded in a recent interview, "We [the NCUA] do not favor mandating federal insurance. We think people should be encouraged that there are privately insured credit unions."

And Bob Bianchini adds, "Without a viable alternative system of insurance, there is no place for an institution to turn if its members believe a new service or program is warranted even though it is not authorized under federal standards. These standards may have nothing to do with the safety and soundness of a particular institution. A dual insurance system provides for competition within regulation, and in the long run, it is the consumer who benefits from that competition."

In spite of the clear advantages of a dual system of supervision and insurance, private insurers and their insured institutions are taking a hard look to identify and correct any weaknesses in the system. Through a revitalized IS&DGA, the funds are cooperatively studying issues such as: Does each fund have the ability to detect and the power to deal with problems as they develop? Are there contingency plans to deal with major failures? Has each fund adequately diversified its risks?

As noted by Tom Gaines, President of the State Credit Union Share Insurance Corporation based in Tennessee: "Private insurers can facilitate deregulation by credit unions by constantly changing their bag of tools to deal with the new products and services consumers are demanding." Private insurance has given all credit unions a critical advantage in servicing their members.

"We (NCUA) do not favor mandating federal insurance. We think people should be encouraged that there are privately insured credit unions."

THE ADVANTAGE WORKS

And the member has benefited, as the record dramatically indicates. For the last 3½ years, credit unions have had one of the most remarkable recoveries of any sector of the economy. In the recession of 1981-82, they were the most vulnerable of all financial organizations because of problems at sponsoring organizations, such as layoffs and plant and military base closings. But credit unions rebounded with vigor.

Share growth at annual rates of almost 20% is more than twice that of their nearest competitor, earnings are up substantially, reserve levels have risen, and membership expansion continues. Moreover, all of the negative signs—liquidations, number of problem credit unions, insurance expenses—are down.

These results are even more outstanding in the face of deregulation, with its new competitive pressures and players. But were these results inevitable? Hardly. Newspapers and television report daily about worsening figures in banking and S&L industries—depression level numbers of failures, record losses, and constant Congressional hearings. Clearly, the success of credit unions is not because "a rising tide (of economic recovery) lifts all boats."

"Diversity among regulators is a means of protecting the industry."

Rather, their success is due to the organizational systems and commitments credit unions have made to their members and to each other. Cooperative share insurance is a vital part of this system. The private funds are pioneers in both the concept and the practice of share insurance. They were both stimulus and example for the NCUSIF's restructuring and they continue to be innovators today. While many factors have contributed to credit union successes, the ever increasing public interest in share insurance has made creative private insurers more vital than ever before. One only has to look at the media headlines, the pessimistic forecasts, and the controversies surrounding the FSLIC's and the FDIC's efforts to adapt to a new environment to realize how fortunate the credit union movement is. Without the energizing force of private insurance, credit unions and the NCUSIF could just as easily still be a part of the economic and political issues affecting those industries.

Private Credit Union Share Insurers - Innovation and Results

by Bert Ely

INNOVATION

Private credit union share insurers have led the way for 24 years in protecting credit union share balances. Since 1970, these agents of change have also represented an important alternative to federal share insurance. This alternative is also key to preserving dual chartering for the credit union movement.

Today, these private insurers, the 14 U.S. members of the International Share and Deposit Guarantee Association (IS&DGA), protect 10 million members in over 3,100 state-chartered credit unions. Today, they continue the innovative tradition first established in 1961 by the Massachusetts Credit Union Share Insurance Corporation.

IS&DGA members led the credit union movement towards share insurance. Now over 99% of all credit unions are insured. IS&DGA members have led in developing sound funding methods for credit union insurers. They have led in developing the techniques that minimize losses in failed credit unions. They have been the proving ground for many innovations later adopted by the National Credit Union Share Insurance Fund (NCUSIF). Operating under the vigilance of their boards of directors and their state credit union supervisors, these innovative insurers will continue to lead the way.

An examination of these innovations, and the advantages they offer to the credit union movement, is in order.

One key strength of any insurer is the adequacy of its reserves. Without adequate reserves, the insurer's promise to pay is a hollow phrase. Private share insurers, recognizing very early the slow process of accumulating adequate reserves from retained earnings, innovated. Every insurer adopted, in one form or another, the deposit method for quickly building an adequate reserve, and for growing those reserves as insured shares grew. Deposits usually equal ½ of 1% to 1% of the savings in each credit union. As each credit union's total savings changes, its deposit with its insurer is adjusted at least annually. Today, some share insurers have even built their reserves to the point that investment earnings are sufficient to maintain an adequate reserves/shares ratio.

NCUSIF COPIES PRIVATE FUNDS

The NCUSIF, long plagued by inadequate reserves, adopted its 1% deposit program only last year. Federally insured credit unions quickly agreed to the 1% deposit plan, in large measure because private share insurers had already pioneered and refined the deposit concept. Now all credit unions have far stronger reserves protecting their shares than are available to protect deposits in banks and savings and loans. The NCUSIF deposit plan is just one example of the innovative competition between the NCUSIF and its private counterparts that has benefited all credit unions since the federal insurer was founded in 1970.

The NCUSIF has also adapted many of the loss control methods previously developed and refined by the private insurers. Closely monitoring every credit union is key to minimizing insolvency losses in those few that fail. All private insurers have well-established monitoring mechanisms based on monthly or quarterly financial reviews, close working relationships with state regulators, and visits to those credit unions showing signs of financial distress. Some of these monitoring systems have even been computerized so that adverse trends in individual credit unions can be quickly spotted.

In this age of deregulation and greater diversity among credit unions, the key to successful supervision of insured credit unions is closeness—physical and psychological—and flexibility, rather than uniform rules and infrequent examinations. The ongoing supervisory interplay between private share insurer and credit union permits the insurer to stay close to the credit union marketplace and thus adapt more rapidly to it than can a federal insurer in distant Washington. Even as the NCUSIF adapts techniques first developed by private insurers, IS&DGA members, each supervising just a few hundred credit unions, stay closer to their insureds than can the NCUSIF to its 15,000 insureds.

INSURANCE FOSTERS FLEXIBILITY

Private share insurance has been especially beneficial to credit union members in the twenty-five states plus Puerto Rico that permit private share insurance. In these states, state-chartered credit unions operate with a regulatory flexibility and forward thinking that is just not feasible for federally insured credit unions, much as the NCUA has tried to be flexible. Consequently, privately protected credit unions can offer a broader range of services to their members and thus maintain their competitive edge with banks and S&Ls.

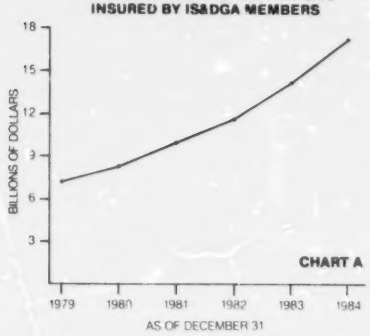
Innovation continues to evolve among IS&DGA members. For example, two insurers already operate in several states, and others may join them to regionalize private share insurance. Half of the IS&DGA members now offer insurance limits higher than NCUSIF's Congressionally restricted limit of $100,000. Several even insure entire account balances. One member also offers excess insurance to federally insured credit unions so that these credit unions can protect account balances higher than $100,000. Almost every IS&DGA member now undergoes an annual outside audit by a qualified CPA firm.

IS&DGA members have also developed various techniques for legitimately minimizing their federal corporate income tax liabilities even as they continue to oppose the recent imposition of this tax. In what is decidedly a double standard, the NCUSIF is exempt from all taxes.

RESULTS

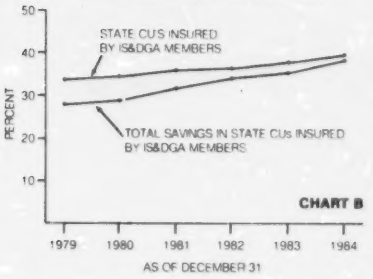
Share insurance is like any other economic activity—the results are what really count. And the results have been impressive. As Chart A shows, total savings in credit unions insured by IS&DGA members have more than doubled over the last five years, growing 138% to $17.6 billion.

TOTAL SAVINGS IN CREDIT UNIONS INSURED BY IS&DGA MEMBERS



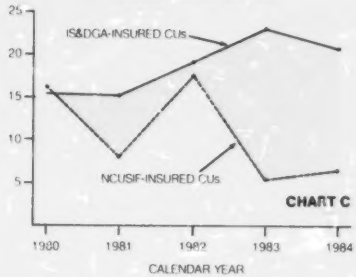
This share growth reflects not only the continuing popularity of credit unions, but also the increasing role IS&DGA members play as insurers of state-chartered credit unions. As Chart B shows, both the percentage of state credit unions insured by IS&DGA members as well as the percentage of savings in IS&DGA-insured credit unions have increased since the IS&DGA was founded in December 1979.

IS&DGA MARKET SHARE GROWTH



In fact, as shown in Chart C, shares in credit unions insured by IS&DGA members have grown at a faster rate since 1981 than they have in federally insured state credit unions!

RELATIVE GROWTH IN INSURED SAVINGS: IS&DGA INSURED CUs VERSUS NCUSIF-INSURED CUs



LOSSES DOWN DRAMATICALLY

More important than growth, however, is the quality of protection private share insurance offers. And here private insurers have excelled by closely monitoring their insureds. Through continually improving monitoring processes, IS&DGA members have trimmed their net insurance losses by almost three-fourths since these losses peaked in 1982. Chart D dramatically illustrates this most favorable trend.

This improvement is particularly impressive in light of the fact that the American economy dipped more sharply in 1982 than it did in 1980. The 1980 decline in real GNP, coupled with the extensive banking deregulation taking place at that time, triggered the relatively high insurance losses of 1981 and 1982. That credit union insurers have done so well since the 1982 recession confirms two facts. State-chartered credit unions have put the worst of the impact of banking deregulation behind them, and private share insurers are better equipped than ever to minimize credit union failures, and losses in those few that fail. Both of these facts bode well for the future of private share insurance, and the preservation of dual-chartering for credit unions.

The loss record for IS&DGA members becomes even more impressive when compared to NCUSIF's record. Chart E illustrates this performance by contrasting comparative loss experiences in terms of losses per insured share dollar. Since 1980, NCUSIF's losses have significantly exceeded the combined loss experience percentage of all ISDGA members. The greatest disparity in performance occurred in 1982 when NCUSIF's losses zoomed to 13.6 basis points per insured share dolar while IS&DGA losses declined to 4.6 basis points. One basis point equals .01%. Even as NCUSIF's loss rate has dropped substantially from its 1982 peak, the loss experience of IS&DGA members has fallen even more dramatically.

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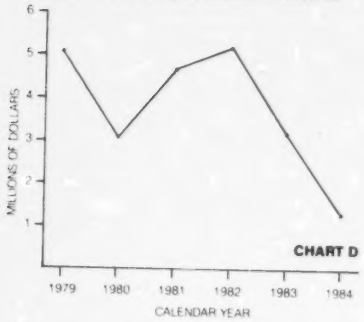
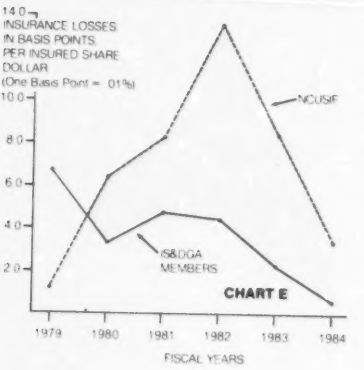
NET CLAIMS PAID BY IS&DGA MEMBERS



CLOSE SUPERVISION BY FUNDS

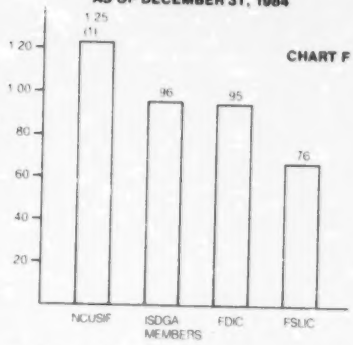
The payoff from close monitoring is seen from another perspective by comparing the accompanying consolidated income statement for IS&DGA members with NCUSIF figures. During 1984, IS&DGA members on average spent more than three dollars in monitoring and administrative costs for every dollar of net insurance losses and reinsurance costs they incurred. IS&DGA members have clearly spent this money wisely to save credit unions and prevent losses. NCUSIF's experience is almost the opposite. In 1984, its insurance losses were almost triple its administrative and monitoring expenses. That's why NCUSIF's 1984 loss rate was four and one-half times higher than the combined loss rate for IS&DGA members.

COMPARATIVE INSURANCE LOSS EXPERIENCE— NCUSIF COMPARED TO IS&DGA MEMBERS



Share insurer reserves continue to be the bulwark protecting credit union members. Here IS&DGA members excel. While NCUSIF reserves as a percentage of total shares now exceed the combined reserves/shares percentage for IS&DGA members, as shown in Chart F, the IS&DGA members' ratio is still comparable with the FDIC ratio and comfortably above FSLIC's ratio.

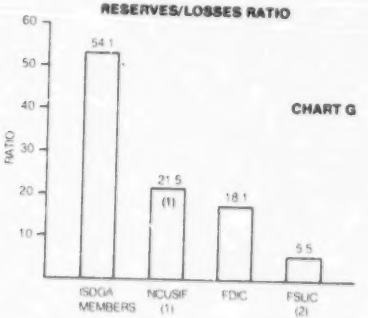
INSURANCE RESERVES AS A PERCENT OF TOTAL SALES/DEPOSITS AS OF DECEMBER 31, 1984



(1) INCLUDES 1% DEPOSIT ASSESSED BY NCUSIF AS OF 12-31-84

The ratio of reserves to recent losses, however, is a much better measure of reserve adequacy. As Chart G shows, IS&DGA members demonstrate two and one-half times as much strength here as does the NCUSIF.

RESERVES/LOSSES RATIO



RATIO OF INSURANCE RESERVES AT FISCAL YEAR-END 1984 TO AVERAGE INSOLVENCY LOSSES FOR THE 1982-1984 PERIOD

(1) Includes the 1% deposit due as of 12-31-84.
(2) Based in part on estimate for FSLIC's 1984 insolvency losses.

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CONSOLIDATED FINANCIAL STATEMENTS OF THE FOURTEEN PRIVATE U.S. CREDIT UNION INSURERS

(unaudited)
(dollars in thousands)

BALANCE SHEET

As of fiscal years ending nearest to December 31, 1984

Assets	
Cash and investments	$184,117
Deposits, assessments receivable from member credit unions	7,549
Interest and dividends receivable	2,615
Other current assets	545
Advances to, assets acquired from member credit unions	4,495
Office furniture and equipment, net of depreciation	1,103
Other non-current assets	521
Total assets	$200,945
Liabilities and Members' Equity	
Accounts payable	$ 718
Deferred revenues	1,100
Reserves for losses	15,203
Loans and other indebtedness	3,298
Income taxes payable	438
Other liabilities	1,209
Total liabilities	21,966
Members' equity	
Refundable deposits	103,201
Retained earnings and other capital	75,778
Total members' equity	178,979
Total liabilities and equity	$200,945

INCOME STATEMENT

For the fiscal years ending nearest to December 31, 1984

Revenues	
Member assessments	$ 6,308
Interest on investments	17,392
Other	2,034
Total revenues	25,734
Expenses	
Operating and administrative	6,222
Net losses and reinsurance expense	1,766
Interest and line-of-credit fees	406
Total expenses	8,394
Pre-tax income	17,340
Income taxes	300
After-tax income	$ 17,040

The credit union movement can take great comfort in the fact that both of the insurance options—federal and private—available to credit unions show greater financial strength than the federal monopoly insurers for banks and savings and loans. The relatively greater strength of the NCUSIF, when compared to the other two federal deposit insurers, highlights the fruits borne by competition among credit union insurers.

The accompanying consolidated balance sheet for the fourteen members of the IS&DGA shows that collectively they had $201 million of assets and members' equity of $179 million. While NCUSIF's fund balance far exceeds $179 million, NCUSIF would need another $1.75 *billion* in members' deposits and retained earnings to achieve the same reserves/loss ratio IS&DGA members have already accumulated.

Bert Ely is a Corporate Financial Consultant located in Alexandria, Virginia. He holds a BBA from Case Western Reserve University and a MBA from the Harvard Business School. Mr. Ely has focused his consulting activities on assisting financially troubled corporations and conducting deposit insurance studies. He has written several articles and papers and spoken on numerous occasions on the subject of deposit insurance reform.

SHARE INSURANCE QUESTIONS AND ANSWERS

Edgar F. Callahan, former Illinois regulator and NCUA Chairman, responds to the most frequently asked questions that have been raised about private share insurance.

Q. Mr. Callahan, in the wake of the crises in the savings and loan private insurance systems in Ohio and Maryland, why do you think private credit union share insurance can succeed?

A. I think private credit union insurance will not only succeed, but I also believe it will be one of the key factors in credit unions' future success. The crises in Maryland and Ohio were savings and loan problems, not credit union problems, or even an insurance problem. All savings and loan insurers, even the Federal Savings and Loan Insurance Corporation, are suffering from the very severe problems of that industry.

More importantly, the private credit union funds are part of a credit union financial system that repeatedly has demonstrated its ability to plan for change so that the financial mechanisms are in place to respond to any emergency or threats.

Moreover, credit unions are unique in this cooperative system of assistance and in their close member relationships. In the event of a crisis of confidence credit unions have repeatedly shown that they are willing to work together in ways the other financial systems cannot.

Q. But how would a private fund stop a run—isn't that the real reason *federal* insurance works better?

A. No. The public seems to have a very short memory. The recent phenomenon of runs started at federally insured institutions—Continental Bank in Chicago and Financial Corporation of America (FCA) in California. In both instances, the federal insurance fund did not put up the liquidity. The Federal Reserve system, along with a consortium of banks, bailed out Continental, and the Federal Home Loan Bank system supported FCA. No insurer by itself has the liquidity to stop a run of its largest institutions without the support of the financial system.

And credit unions insurers have that system in place, and have had it in place for years. The corporate credit union network, with U.S. Central at the hub, provides liquidity from throughout the country to meet whatever temporary shortfalls may occur. That pool of funds now exceeds $11 billion. U.S. Central in turn can tap the private market for funds. Backstopping this is the Central Liquidity Facility (CLF) to which virtually all credit unions belong due to the joint membership/application of the corporate central network. Private share insurers by law have the right to borrow from the CLF which in turns funds its loans through the Federal Financing Bank, a part of the U.S. Treasury.

Credit unions have the same ultimate liquidity lender, the Federal Reserve, as do all banks and S&Ls. And *in addition*, all credit unions have a complete second system resting ultimately on the CLF. In the final analysis, a privately insured credit union has more liquidity options than a federally insured bank or S&L.

Q. Even if this is true, doesn't the public prefer "federal" insurance? Isn't that really the ultimate test of safety and soundness?

A. If the answer to that were yes, then the strongest bank in the U.S. today should be Continental, which is not only federally insured but owned, in a practical sense, by the FDIC. Instead the marketplace still rates Continental at the lower end of the quality scale.

What the public wants, whether this be an individual consumer or the "invisible" forces of the marketplace, is confidence in the integrity and stability of the institution with which they do business.

For example, I was in Rhode Island several weeks ago when the local press had just published that Consumer Credit Bank was phasing out its consumer deposit program in several states to be replaced by wholesale funding sources such as commercial paper. This was a business decision based on the relative costs of different funding sources. However, because of a lack of communication, the local press portrayed this as a concern about private insurance since deposits were insured by Rhode Island Share & Deposit Indemnity Corporation. A three day barrage of front page stories began that caused people to line up outside the Commercial Credit Bank offices in scenes similar to those in Ohio and Maryland.

During that evening we visited a nearby credit union Board and asked what kind of a day they were having. We learned that for the first two days of this "run" about $500,000 had moved from the bank to this credit union which was also insured by RISDIC. These credit union members trusted the credit union, knew about its community base and support, and had no problem putting their funds there.

Q. But haven't there been instances of runs on privately insured credit unions?

A. Absolutely not. We have yet to find one case of a net deposit outflow from any privately insured credit union in the country before—or after—events in Ohio, Maryland and Rhode Island. In fact the only credit union "run" I'm aware of was at an NCUA insured credit union in the midwest—and again the issue wasn't insurance per se but the perception of problems in the institution.

Q. But how would a manager of a privately insured credit union compete against advertising that tells people to place their savings in a federally insured institution? Isn't the implication that federal is better or safer?

A. That is certainly the message some would like to leave. I'm sure, in fact some of those types of ads are running right now in California. And in the face of this kind of effort, one of the largest privately insured credit unions in the heart of this market has grown over 10%, or $40 million, in just the first six months of this year.

In fact, I think the more an institution, be it an S&L, credit union, or bank begins to tell people that they should do business with them because they are federally insured—that that's the main message—the more consumers are going to start asking what's wrong. Why isn't the bank or S&L telling us about its services or rates or conveniences. Fear does motivate some people some of the time, but after a while people also start to suspect that they are being manipulated and that the real concern these institutions have is with ***their own*** safety and soundness—but they'd prefer others didn't focus on that.

Q. Haven't there been a lot of conversions from state to NCUA insurance by credit unions? Doesn't this indicate that managers or Boards or members want the "perception of safety" brought by NCUA?

A. No, there have not been a lot of voluntary conversions. There have been two states where credit unions were not given a choice but told in one case by the insurer (North Carolina) and in another by the Governor's office (Wisconsin) that private insurance was being phased out. Credit union Boards and managers were not given a choice. I think those were "knee jerk" reactions to the media stories about events in Ohio and that the history, benefits, and credible nature of credit union private insurance were not understood.

To date, the truly voluntary switches to federal insurance have been far fewer in number and much less in dollars than the change to private insurance prior to the beginning of this year. And in fact, and this has been ignored by many, even after the public discussion of the S&L events in Ohio and Maryland, there have been a half dozen conversions to private insurance from NCUA.

Q. But aren't some regulators, as in Massachusetts, telling credit unions to go federal without formal law changes?

A. Yes, the bank commissioner in Massachusetts is very public in his opinion. He thinks all financial institutions in his state should be federally insured and he believes that insurer should be the FDIC. In fact I suspect he is comfortable with the thought that all financial institutions should be banks. But I think his point of view is an exception.

One of IS&DGA's goals is to work more closely with state regulators, administrators and legislators to help them understand how private credit union insurance has made credit unions in their states responsive to their needs. Private insurance preserves the supervision priority of the state. You have yet to read about a private insurance corporation pre-empting state law, but this has happened on numerous occasions at the federal insurance level.

The dual chartering system really only works if there is a dual insurance system. Credit unions' incredible growth has been, in my judgment, due to the flexibility and responsiveness provided by having the only meaningful dual chartering system in this country. To continue these successes in the future will depend no less, in my judgment, on a strengthening of this system.

Q. But the bottom line is, can it work? What can private insurance offer that NCUA cannot?

A. Cooperative credit insurance does work. Not one cent of savings has ever been lost by a member in an account insured by IS&DGA Corporation. Private insurers have been meeting credit union needs for almost twice as long as NCUA insurance. So the results are there, and the funds have grown and prospered.

One critical aspect for continuing success is the ability to control losses. And in this area, the expense history of private insurance is many times better than NCUA's. Look at the situation in Wisconsin. The Wisconsin Credit Union Savings Insurance Corporation, which insures almost $2.3 billion in savings, has had only $1.2 million of insurance losses in its 15 years of operation. That loss ratio per year is virtually nil and is a real tribute to the effectiveness of a local insurer.

But that situation highlights that there also has to be a *will* for private insurance to continue—will on the part of managers, boards, regulators and legislators, or even the best track record in the world cannot turn the tide.

Private insurers have credit unions' managers on their boards, and they can act quickly to help with problems or to modify programs. They can talk with Leagues, with state regulators and credit unions as ***peers*** about local conditions and local needs. I firmly believe that if the will of the credit union community and the state regulatory system to support private insurance is maintained, then at this time next year you'll see a dynamic, responsive and innovative system of private insurers. The incentives are there and the opportunity is there to take IS&DGA members to new levels of creativity.

Q. How is IS&DGA going to help these funds?

A. First of all, IS&DGA is an integral part of the system. The private insurers will have to continue to innovate to be competitive with NCUA. There are several areas where this now occurs in the extent and amount of coverages and in flexible pricing and rebate formulas. While the press discusses savings insurance almost solely in terms of timely payouts or in an assisted merger context, that represents a very small portion of insurance activity. For the 99% or more of institutions that will not be liquidated or merged involuntarily, insurance effectiveness is a matter of responsive supervision, state-of-the-art tools of analysis, assistance to management in the credit union, and meaningful two-way communication about changes and needs in the marketplace.

Q. But, if you were the manager of a privately insured credit union what would you tell depositors who asked why they should put their funds with you?

A. I think that depositors first want to know that their financial needs will be met by a responsive, well-managed institution. If a credit union isn't doing that, insurance will not cause the member to put in more money. Most money leaves a credit union *not* in response to an insurance worry, but when the credit union can't meet market rates of savings. Remember the largest flow of funds out of the federally insured system was to the uninsured money market mutual funds before deregulation. This flow amounted to over $200 billion dollars. Insurance per se will not attract or keep a member if the institution is not performing its primary business purposes in a credible way.

The example: service and products that are responsive to local needs and markets are the hallmarks of privately insured institutions. They pioneered deregulation of shares and savings before federally insured institutions. As a result savers received a higher rate of return on accounts based on local conditions, not account terms mandated on a nationwide basis by regulatory fiat.

If the members still insisted that they would only be satisfied with federal insurance then I would point out that their largest asset, their home equity, is not federally insured, that their most important financial contingency, life insurance, is not federally insured, that the most necessary of modern day conveniences, their auto, is not federally insured and finally the vast majority of retirement funds, the future "nest egg" that we all build for, is probably not federally insured. Federal insurance is not the frequently held notion of consumers about safety in any area of our life or commerce. And it's simply that it's needs to be the situation for savings insurance.

Q. You've got an argument on this point from a lot of people. Bill Isaac, FDIC Chairman, is quoted as saying, "There is no reason for private insurance," and even Ed Gray, FSLIC Chairman, testified that, in my opinion the public would be better protected by requiring federal insurance for all depository institutions.

A. Well, I worked with both men when I was at NCUA. And I think they would probably be the first to admit that they are not familiar with the credit union system and its history of private insurance. So, in fact, their statement is more a statement of point than a practical one since credit union private insurance does work. Credible federal insurance and, in fact, works so well that we copied the main tenets when we constructed the NCUA fund.

But you also have to bear in mind that there are a host of other messages in those statements. I think it's natural to want a monopoly on any economic activity.

Competition cannot only expose an organization's shortcomings, it can create a much more complex operating environment. Remember the insurer is a regulator. In a dual chartering system with comparable state and federal powers, dual insurance operates as a check and balance on the other regulator. A single federal insurer might make life somewhat less complicated, but I question whether it is in the industry's interest, in the consumer's interest, or in the state's interest. I think the record is clear for credit unions that a dual insurance system works, and works well for everybody.

Q. How does it work well for federally insured credit unions?

A. Private insurance is probably the single most important reason why federally insured credit unions have a responsive federal insurance and regulatory system. Without options there is one system of regulation, of reserving, of investments, of risk evaluation, and one standard of reporting. And while uniformity might work for a time, one has only to look at the crises in the other financial systems to see what happens when an industry has had one uniform approach to a rapidly changing marketplace imposed by laws and regulations.

As I said earlier, almost all of the significant innovations in credit unions have come from the state chartered system.

Q. But how do you answer the national columnist who states that "under normal circumstances private insurance could do the job, but these firms lack the bottomless pockets that may be needed to reassure the public in the event of a major loss?" Or the claim in a credit union brochure that private insurance and federal insurance are distinctly different, but "only one, federal insurance, is backed by the financial strength of the United States Government?

A. All of the money spent (expensed) in *all* private and federal insurance funds comes from the insured institutions themselves, not the government. This is in the form of premiums or capital. If there is a weakness in a fund, as there has been periodically in every fund, the source of money for losses or new capital for each fund has always been first in the industry. Every fund, whether private or federal, relies upon external sources of liquidity to meet the most extreme needs. And in all cases, private or federal, the ultimate liquidity source is not the insurance fund, but the Federal Reserve System and for credit unions—The U.S. Treasury via the CLF.

In cases where government has had to step in to "bail out" a fund, as occurred in Maryland, Ohio and California, the "bail out" was to dissolve the fund.

To imagine a situation where the general public's tax funds would be used if a state or a federal level to bail out or cover losses in an insurance fund without at the same time radically altering the fund is inconceivable. The state legislature or Congress will demand a tradeoff if public monies are needed to save a specific industry's fund—no matter how vital that industry thinks it may be to the general public. The tradeoff in the past has been the dissolution of the fund and forcing the institutions to go elsewhere for insurance or to liquidate. I think that is what would occur if any credit union insurance fund, even NCUA, ever went outside the credit union system for capital to save the fund.

As for the columnist who said private funds lack "the bottomless pockets" that federal ones do, this person hasn't been living in the real world since the last political cycle. In the face of the budget deficit pressure, I know of no industry, special need, or group that would claim that Washington is a "bottomless pocket" for its rescue. That is both naive and misleading. If an economic disaster that required a massive federal bailout, should ever strike this country I suspect the entire system would become like Continental Bank, government owned and directed.

Q. But isn't size important? How can 14 private funds compete with one major federal fund?

A. NCUA does have certain economies of scale in administering its programs. However, most of the costs of insurance are in the losses suffered in mergers, liquidations, and temporary assistance. NCUA's ability to perform at anywhere close to the result of the private funds in this area of activity has yet to be demonstrated.

In fact, I think this is where the private funds have the major advantage. Because of the structures of their organizations, in which the insurers are represented on the Boards of the funds, I think there is built-in direction and incentive for both management and privately insured credit unions to solve problems as economically as possible.

While we tried to incorporate market-like pressures and disclosures in NCUA's insurance operation, government basically knows how to do one thing to solve problems—spend money.

So while size can help, in the insurance area responsiveness, being close to the situation, and fast action are ultimately much more critical in efficient problem solving than size. And history shows the private funds can compete—that's one reason while I was at NCUA we were forced to look for a better way than second premiums to build fund equity.

Q. Why did you choose to make this effort for IS&DGA one of the first commitments of your firm? Some think you just signed up for a ticket on the Titanic.

A. I think the question of choices and options is critical for credit unions' future. Chip's, Bucky's and my move from government was to become a part of the credit union movement. Without choices the vitality, the creativity, and the responsiveness to member needs that has really made credit unions unique in this country's financial system would be seriously eroded. The members of IS&DGA have been part of this pioneering spirit. We believe that this is a very critical opportunity for credit unions, for the private funds, and for us personally. We have supported private insurance since 1977 in Illinois and we think that credit unions will respond and continue to support these insurers if the issues at stake can be clearly presented.

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Callahan and Associates

Callahan & Associates is a credit union consulting firm located in the Washington, D.C. suburb of Bethesda. The company was formed in May, 1985. The three senior partners, who were most recently the Chairman, the General Counsel, and the Director of the Office of Programs of the National Credit Union Administration (NCUA), bring over 25 years of credit union experience to the new company.

The firm serves credit unions and credit union organizations throughout the United States. Services include expansion studies, financial troubleshooting and turnaround, credit union organization, merger evaluation, strategic planning, expert testimony, education, government affairs consulting and data-based financial analysis and reference listings. To develop management tools for credit unions, the firm has purchased under the Freedom of Information Act the semi-annual financial reports filed by credit unions with NCUA. These data based tools and other self-evaluation products are designed to assist individual credit unions to maximize their opportunities and performance.

In June, Callahan & Associates was chosen to manage the IS&DGA. In addition to joint efforts on behalf of the 36 cooperative credit union insurers, the firm works directly with individual insurers to review and strengthen critical areas of organizational activity.

The professional staff of Callahan & Associates includes:

Edgar F. Callahan served as Chairman of the National Credit Union Administration from 1981 to 1985. This agency is responsible for chartering and supervising over 10,000 federal credit unions and insuring 5,000 state chartered credit unions. Prior to this, Mr. Callahan was Illinois Director of Financial Institutions and from 1975 to 1977 was Illinois Deputy Secretary of State. Mr. Callahan received his Bachelor's and Master's degrees from Marquette University.

Wendell A. ["Bucky"] Sebastian is a lawyer with 15 years experience in government service. From 1982 to 1985, Mr. Sebastian was General Counsel to the NCUA. From 1977 to 1981 he was the General Counsel and office administrator of the Illinois Department of Financial Institutions. Mr. Sebastian received both his [illegible] in Philosophy and his Juris Doctorate from Loyola University in Chicago and in 1981 completed the program for Senior Managers in Government from the John F. Kennedy School of Government at Harvard University.

Charles W. ["Chip"] Filson from 1981 to 1985 was President of the Central Liquidity Facility of NCUA and Director of the Office of Programs, which included supervision of the agency's insurance fund (NCUSIF). Prior to joining NCUA, Mr. Filson was supervisor of the Credit Union Division of the Illinois Department of Financial Institutions. Mr. Filson is a magna cum laude graduate of Harvard University. In 1968 he received a BA/MA in Politics, Philosophy and Economics from Oxford University where he was a Rhodes Scholar. In 1981 he received a Masters of Management degree with distinction from Northwestern University.

Geoff Bacino (Executive Director, IS&DGA) was most recently the Public Information Officer for the Mayor's Office in Fort Wayne, Indiana. A Rockford, Illinois native, Mr. Bacino has Political Science degrees from Rock Valley College and Indiana University.

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The CHAIRMAN. Thank you, Mr. Filson.

Why is non-Federal insurance something that federally insured and federally chartered credit unions would be interested in or support if they have a strong system, which they do? You know what we did last year to increase the capitalization and so on. Why are they concerned about an alternative? I'm not arguing one against the other. I'm just saying that if they already have one that's good and strong and no problems, why are they interested? Or would they be interested in it?

CHOICE AND OPTIONS IS THE KEY

Mr. FILSON. I think the key to the success of credit unions is choice and options. When there is no choice, when there is only one option, I think the flexibility and responsiveness that all financial institutions need in today's marketplace is thereby limited. The choice given through private insurance helps not just the privately insured credit unions, but it helps Federal credit unions be responsive as well.

And the example I gave in the testimony of what was done with the Federal insurance fund is a specific example where the Federal Government was able to learn from the experience of the private sector.

The CHAIRMAN. I wonder about the applicability of credit union non-Federal insurance experience to other financial institutions. Some people have said, look, it has worked here, why can't it work there? Also, Mr. Artemenko certainly made the point that credit unions were different. I agree. They are different. So do you think that their experience is transferable to other types of institutions?

Mr. FILSON. I concur that credit unions are different and there are some factors in their structures, in their history, that have given private insurance a leg up, if you would, on Federal insurance and in the member relationship and attitude toward that insurance.

I think I would be more than happy to work with the committee and the other agencies to see what parts of that experience might in fact be transferable to their industries.

I think the major lesson that we're saying is that options work, not that this specific option in this way is one that they would want to pick up. But I would be more than happy to explore where the options that have been tried and found successful in the credit unions might be openings that the other industries would want to try as well.

The CHAIRMAN. Well, of course, a credit union always has the option of being State or federally chartered. They don't have to be federally chartered.

Mr. FILSON. That's correct.

The CHAIRMAN. That choice is always there, too.

Mr. Ely, you advocate private insurance for depository institutions. You make some very good points. You've done a lot of detailed studies on it. This is obvious from your appendixes. What convinces you in the current climate that it would be acceptable to depositors? No matter how good a private system you can come up

with, with what's been going on lately, how do you sell that idea to the public?

CREDIBILITY FOCUSES ON LIQUIDITY

Mr. ELY. Well, I think the credibility really focuses more on liquidity; that is, can the depositor go to the bank and get his money out? The essential agency in that regard is the Federal Reserve, the lender of last resort. The key to any type of really meaningful depositor protection reform is to legally mandate that the Fed will serve as lender of last resort, no questions asked. There has to be 100 percent certainty that the Fed will perform.

Once you have provided a Federal Reserve response for all depository institutions, and for all deposit balances, then the day of the bank run is gone because every depositor will have assurance from one of the most highly respected institutions in the country, the Federal Reserve, that cash will be on hand if they want to withdrew it from their bank.

This Fed involvement would take financial concerns about banks out of the broad public area of concern and focus it more in terms of the Fed's concerns about not taking any losses, the banks' need to be able to stay afloat, and the concerns of insurers or guarantors. This would concentrate the failing bank problem in that regard and focus on the real risk, which is the insolvency risk.

I argue that had we had an explicit policy in this country that every dollar deposited in depository institutions was insured, we would have never seen a run on Continental of the magnitude that we did. We wouldn't have seen any run at all. The insurer of Continental would then have been able to come to grips with the insolvency loss potential in Continental without having had that situation aggravated and the cost increased by virtue of the run. That run was very destructive to Continental. To the extent there is going to be any insolvency loss to the FDIC or to the extent that Continental's stockholders will get wiped out, it was increased by virtue of that run.

This ultimately comes back to what gives people confidence—the Fed and its willingness to lend money.

The CHAIRMAN. Well, do you think people are sophisticated enough—I don't have the feeling when we're talking about the Fed people—to understand that concept when you get some runs on FDIC- and FSLIC-insured institutions. Do you really think you can sell that, or how long it will take you to sell it, that the Fed is standing there stalwart? Most people don't even envision the Fed in that role. They have become accustomed to hearing about monetary policy and interest rates, not as a lender of last resort. I don't feel that concept exists. In other words, I'm getting into the psychology that's out there in the marketplace and I wonder how you sell this whole concept. You may sell me, but I deal with the general public all the time and I think you would have a hard time convincing them.

Mr. ELY. Well, 52 years ago the public had to be sold that the FDIC meant something.

The CHAIRMAN. Well, I agree, but I don't think we can wait 52 years to sell them on a new idea.

Mr. ELY. No, the FDIC concept sold very quickly. Further, when you look at runs today on federally insured institutions, you're basically talking about runs by relatively large, sophisticated depositors. Many of them do know that it was the Fed, not the FDIC, that pumped $7 billion into Continental to keep it afloat last summer and it's the Fed that pumped a lot of money into Franklin National, into First National Midland. and so forth.

What it comes down to is this: the first time the Fed delivers in a banking crunch will be like the experience that happened when the FDIC came into being. The massive bank runs that we were having up to the banking holidays in 1933 basically ceased. There were bank failures after that, but runs in effect stopped. So again, it comes back to the Fed demonstrating that it will act in a totally convincing manner and, second of all, that every dollar of deposit is protected. Then, people will have no reason to run.

Mr. FILSON. Mr. Chairman, I might just add that insurance doesn't stop runs. The only thing that stops runs is cash. And in the credit union system, in addition to the Federal Reserve System which credit unions became eligible for some years ago, they have the Central Liquidity Facility which borrows through the Federal Financing Bank. So insurance, per se, isn't going to change people wanting to take their money out, whether that's Federal or private, if they perceive an institution with a problem. And while we refer to Ohio and Maryland situations and say, therefore, private insurance can't be credible, the phenomena of runs started at federally insured institutions, Continental and Finance Corporation of America.

I had an experience about a month ago up in Rhode Island. Rhode Island has a private credit union share insurance fund that until about 6 months ago also insured a substantial number of thrifts. One of their insurance was Commercial Credit Bank, which—the Commercial Credit Corp. has some deposit-taking activities in a number of States, and announced on a Friday that they were going to phase out their deposit-taking activity and fund those deposits through other sources, wholesale money sources, because the funds were cheaper.

That got miscommunicated in the papers and the papers portrayed it as a lack of confidence in private insurance. And sure enough, when that article appeared in the Providence papers on that Monday morning there were lines outside those institutions and then the next day the press all came down and took pictures and so on.

Well, coincidentally, we just happened to be there on Tuesday when this was reaching its peak seeing a credit union that was privately insured and whose board was considering switching to Federal insurance and we asked them before going into the board meeting, "What kind of a day have you had?" And they said, "Well, we picked about $500,000 in deposits from the Commercial Credit Bank down the street where people are taking out their money." That credit union was insured by the same institution that insured Commercial Credit Bank.

The point is that individuals have confidence in their institution and when that confidence goes, insurance isn't going to replace it, whether it be Federal or private. When they run, they need cash.

And, of course, the largest run occurred on federally insured institutions in the early 1980's before deregulation to the uninsured money market funds. So the first element of confidence is professionally run and well-managed institutions.

The CHAIRMAN. Well, I agree. When you cite Continental again, though, I think you have to look at the situation there. The primary run at Continental was not little depositors removing their funds. It was the biggies with huge amounts of money in there that lost confidence. Because Continental really didn't have a retail deposit base. They couldn't branch across a county line, let alone across a State line.

So I agree with you, it's cash they want. But in Continental's case, to use that as an example, I don't think is quite fair because it was a big wholesale bank that had people taking out $30 million at a time, yet there was no great run of individual depositors.

BANKS WOULD INSURE ONE ANOTHER

Mr. Ely, you advocate risk-based premiums and under your system banks would insure one another. I would assume that before one bank would insure another, it would insist upon a detailed review of the second bank's loan portfolio. Now on what basis do you assume that one competitor wants to share all of that detailed information with another one?

Mr. ELY. First I envision syndicates of banks guaranteeing the deposits of other banks—small syndicates for small banks, large syndicates for the large banks—and doing it through an intermediary, most likely insurance brokerage firms since they already are in the business of putting together what effectively are insurance syndications, which is what reinsurance is all about.

This syndication mechanism would incorporate an ongoing monitoring process, calculating premiums and monitoring the guaranteed bank. Sufficient protection would be built into the monitoring process so that bank "A" would not in fact be looking at the loan portfolio of bank "B". Instead, it would rely on the overall numbers for bank "A" that measure what its ever-changing level of risk is. For example, guarantors would look at the relationship of total loans to total assets. This is largely public information right now. There would be no need, in my opinion—and it would also be a monumental job if every bank in the country looked at everybody else's individual loan portfolios. That, of course, would also cause all kinds of confidentiality problems.

The CHAIRMAN. Gentlemen, do either of you have any closing comments you wish to make?

Mr. FILSON. No, sir.

Mr. ELY. No, thank you.

The CHAIRMAN. Thank you very much for your willingness to testify.

We will resume these hearings in September. The country will be safe during the month of August. Congress will be out of session.

[Whereupon, at 11:45 a.m., the hearing was adjourned.]

[Response to written questions of Senator Garn follows:]

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FEDERAL DEPOSIT INSURANCE REFORM

Questions Posed by Senator Garn to Bert Ely

and Answers Submitted by Bert Ely

Q1 - Should a federal insurance agency be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed institution with any profit after administrative costs arising from the transaction returned to the original stockholders?

Yes, assuming we are talking about federal deposit insurance agencies and the depository institutions they insure. Before expanding on this answer, allow me to point out that there are two alternatives to an arranged merger when disposing of a failing or failed bank -- liquidation or recapitalization accompanied by new management. The latter alternative effectively changes the management control of the institution while maintaining its independence. The recent change in control at the Bowery Mutual Savings Bank, accompanied by its conversion to a stock corporation, is an excellent example of recapitalizing a failing depository institution and installing new management in it.

Federal law does not obligate deposit insurers to lose money as insurers. In fact, one can argue that deposit insurers should never lose money since they should take over and dispose of a failing depository just as it exhausts its last dollar of equity capital. After all, deposit insurance was created to protect depositors, not to provide a blank check to incompetent or fraudulent bankers, and their shareholders. To wait until a bank has "failed," i.e. become insolvent, is to wait too long; therefore, it is important to grant a deposit insurer the right to assume control of a failing institution before it becomes insolvent so that the deposit insurer can minimizes his losses through whatever course of action will do just that. Taking control of failing banks faster would almost always be in the best interest of innocent stockholders; i.e. they might recover some portion of their investment instead of losing all of it.

The Conference of State Bank Supervisors (CSBS) states that failed banks should be kept open beyond their moment of failure to serve broader public policy purposes, at the expense of the FDIC. Because FDIC premiums are an operating expense of banks, all costs incurred in keeping a bank open even a minute beyond its moment of insolvency are borne solely by surviving banks. In effect, the CSBS is asking bankers to finance a public benefit, i.e. keeping open the doors of a failed bank. It would be more appropriate to use general state tax revenues to keep open failed, state-chartered banks rather than FDIC monies. I trust state legislators would quickly find better uses for public funds.

Q2 - If the burden of mismanagement were placed squarely on the managers and stockholders and most failures were handled through a purchase and assumption at an earlier stage - immediately or through a conservatorship - regardless of size - wouldn't this dispose of the fairness question as it relates to large and small institutions? Why couldn't a Continental type solution be applied to failing small banks? If an insurance agency is funded totally by institutions is there a federal subsidy?

Yes, with regard to the first question. However, liquidation and more importantly, recapitalization and new management should never be ruled out as an alternative to a purchase and assumption transaction, particularly for larger banks. As a practical matter, recapitalization and new management is probably the only way to dispose of failing banks and S&Ls with more than $10 billion in assets since (1) liquidation would be unnecessarily costly to the deposit insurer and (2) an assisted merger may result in excessive asset concentration in the market served by the merged institution.

Desirable as recapitalization and new management may be for smaller banks and S&Ls, it often is not a feasible alternative for them since there usually is insufficient going concern value to attract capital and new management to smaller, failing depositories. Hence, an assisted merger or liquidation often is the only alternative open to a small, failing depository, however much a Continental-type solution might be desired. In this regard, failing depositories are just like businesses entering Chapter 11 bankruptcy -- the bigger the business, the greater the likelihood it will successfully reorganize and emerge from Chapter 11 as a financially-viable, free-standing company; the smaller it is, the greater is the likelihood that it will be liquidated or, less likely, merged into another company.

Deposit insurance is no more subsidized by the federal government than is any other business expense that is deductible for the purpose of computing a business's taxable income. One can argue, however, that S&Ls benefit increasingly from the implied federal guarantee supposedly backing up the now bankrupt Federal Savings and Loan Insurance Corporation (FSLIC). To date, though, no actual tax dollars have been put into FSLIC.

Q3 - Is there a place for self-regulation in the banking industry that draws on the talent within the industry? If so, how could concepts of self-regulation be included in the federal supervisory system?

Self-regulation, as posed in this question, is an interesting but miscast idea as it pertains to banking supervision, which today exists primarily to protect the deposit insurance funds, and ultimately stockholders in depository institutions. Self-regulation mechanisms have, in fact, been created to protect consumers, not stockholders and insurers. For instance, the various professions, such as doctors, lawyers and CPAs, and investment firms, through the National

Association of Securities Dealers, practice self-regulation to protect the consumers of their services so as to ward off governmental protection of those consumers. These fierce competitors certainly do not exercise self-regulation to protect themselves from each other.

In banking, though, consumers already are protected through deposit insurance, up to $100,000. Beyond that, they can protect themselves by withdrawing their funds from the bank. To the extent that bad banking increases deposit insurance losses, it is stockholders in depository institutions that ultimately pay, not depositors, except those hapless few with uninsured balances in the failed banks that are liquidated. The 150% increase in FSLIC assessments this year is ample evidence that stockholders bear the cost of bad banking, or in this case, the cost of poor S&L funding and asset management practices. The reduced FDIC premium rebates of recent years also provide this same evidence.

Ultimately, risk-sensitive deposit insurance premiums would offer the best, and most efficient, form of banking supervision, particularly as this form of supervision would protect both insurer and stockholder interests. Consumer protection, through deposit insurance, would continue unchanged while risk-sensitive deposit insurance premiums, with their consequent impact on the earnings of individual depository institutions, would quickly signal risky banking practices in individual institutions to those persons who can most quickly and effectively act on those signals -- the directors and stockholders of the risky institutions. Because an insurance contract is, in reality, a regulatory device, marketplace discipline, through variable deposit insurance premiums, could largely replace government regulatory discipline.

The only real impact self-regulation would have on the banking industry would be to foster anti-competitive patterns of behavior. Neither the industry nor the public needs this.

Q4 - What is your view of permitting federal regulators to require institutions to pay special assessments for the increased examinations made necessary by their classification as a problem institution?

This is a fine idea, within the context of flat rate deposit insurance premiums, but one with likely limited impact because the special assessments would probably be quite small. In 1984, the FDIC's <u>total</u> operating expense equaled just .86 of one basis point of average total deposits in commercial and mutual savings banks. (One basis point equals 1/100 of one percent.) Based on this statistic, how large would these special assessments be? One basis point? Two basis points? However large, they will hardly discourage unnecessarily risky banking. Their incremental impact on premium rebates to soundly run banks will also be small and, of course, there will be no rebates to well-run S&Ls.

With risk-sensitive premiums, there would be no special assessment problem, per se, since the cost of increased

examinations, to the extent they were really necessary, could be incorporated in the premium.

If special assessments are to be made, the question then arises as to how to assess them. Allow me to suggest one arbitrary, yet simple method -- base them on CAMEL ratings. For instance, banks with CAMEL ratings of 1 or 2 would pay no special assessments while banks with CAMEL ratings of 3 to 5 would pay progressively higher assessments.

Q5 - If regulators are rarely surprised by a bank failure - isn't the answer swifter or more appropriate regulatory action rather than increased market discipline? Wouldn't giving the regulators the ability to close an institution earlier be appropriate? Should a regulator require bank management to file a confidential bank failure plan approved by its board of directors if it falls a certain percentage below its minimum capital level for a specified period of time?

Failing banks should be disposed of faster, but ideally as a consequence of market discipline transmitted through risk-sensitive deposit insurance premiums. If the depositor protection mechanism is to continue to be saddled with flat-rate deposit insurance premiums, then certainly regulators should be permitted to close failing banks before they become insolvent. However, swifter or more appropriate regulatory action will become an increasingly less satisfactory substitute for market discipline expressed through risk-sensitive deposit insurance premiums. Why? Because government regulation works best, to the extent that it ever works, in a homogenous environment, i.e. when all the regulatees look alike and can be measured against rules applied uniformly. Banking deregulation, however, has fostered heterogeneity in the banking industry, and with it a less efficacious regulatory environment. The last five years certainly demonstrate this point. Government banking supervision, although supposedly better able to deal with heterogeneity than regulation, also seems increasingly unable to cope with banking's growing size and complexity.

Based on my many years of experience working with bankrupt businesses, I would state categorically that failure plans would be worthless, in large part because the officers and directors of a failing business are almost always unable to deal with the primary cause of failure -- themselves. Far better to tell the bank's officers and directors this: let capital drop below X% and you are out, and then pull the trigger if capital does drop below X%.

Q6 - There appears to be strong support for required risk-based capital - as a method of calculation of capital or as a supplement to the flat rate capital ratios. Would this necessarily lead to higher capital standards? Is there any need for legislation in this area if such risk-based standards were to be applied equally to all institutions?

The risk-based capital concept, which has stirred much interest in recent months, is intertwined with but

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potentially is less desirable than the concept of risk-sensitive premiums. This intertwining dictates that risk-based capital, which carries a cost of its own, be discussed in the context of risk-sensitive premiums. Why are the two concepts effectively different sides of the same coin? Because of the interplay between capital levels and the amount of the risk-sensitive premium; i.e. as capital in a depository institution increased, for a given level of riskiness, its risk-sensitive deposit insurance premium would decrease, and vice versa. Alternatively, as capital varied with the degree of risk, the risk-sensitive premium would hold fairly constant.

There is a second reason why risk-based capital and risk-sensitive premiums have common roots. Equity capital in any organization, apart from serving as a source of funding, serves the additional function of being the first form of capital to absorb losses. Insurance, which risk-sensitive premiums would purchase, is nothing more than a contingent claim on someone else's capital. Thus, depositors can be equally protected from losses through an adequate cushion of equity capital in their depository to absorb losses or, alternatively, be protected by insurance that can draw in a like amount of capital to absorb whatever losses actually occur.

In the first instance, capital is already in place on the contingency that it may be needed to absorb losses; in the second instance, capital can be drawn into the depository to absorb losses as they occur. For this reason, a depository can theoretically operate with zero capital, provided its deposit insurer is adequately capitalized. In a real world situation, risk-sensitive premiums would optimize a depository's reliance on its own capital base versus its contingent claim on its insurer's capital; i.e. risk-sensitive premiums would achieve the lowest total cost of providing a capital cushion under a depository's deposit liabilities by balancing off the cost of equity capital against the cost of deposit insurance. In this regard, it is interesting to note that the money market funds, with two exceptions, operate with zero capital and no deposit insurance. The money-market funds are, admittedly, an extreme example; however, they represent an excellent real-world example of what could be.

While risk-based capital and risk-sensitive premiums are essentially the same, risk-sensitive premiums offer much greater flexibility than risk-based capital in matching a depository's everchanging level of risk with the capital -- directly invested or contingently available -- needed to underpin that risk. For example, if a depository's risk increased by one percent from one week to the next, its insurance premium could go up one percent to match the increase in risk. Likewise, if the depository's risk decreased in a short period of time, then its insurance premium could also drop quickly. Capital levels could not fluctuate that rapidly with the same efficiency that premiums could fluctuate. Therefore, deposit insurance priced with

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risk-sensitive premiums would be more efficient and therefore superior to risk-based capital.

There is, of course, one rather parochial yet understandable reason why some depositories, specifically the healthier S&Ls, prefer risk-based capital to risk-sensitive premiums -- they want to minimize the premiums they pay to FSLIC. There are arguments on both sides of this point of view. On the one hand, if the healthier S&Ls pay lower premiums by virtue of risk-based capital, then a correspondingly larger amount of general taxpayer monies are going to be needed to cover the cost of FSLIC's looming insolvency. On the other hand, one can argue quite properly that the cost of bailing out FSLIC should be shouldered totally by the taxpayer and not partially by the healthier S&Ls since they have done nothing to contribute to FSLIC's bankruptcy.

All of this discussion prefaces this observation -- risk-based capital will be just as difficult for the federal deposit insurance monopolies to implement, and just as laced with political potholes, as risk-sensitive premiums have proven to be. It is interesting to note that for all of the support regulators have given recently to risk-based capital, not one has offered a specific plan as to how capital levels would be calculated on a depository-by-depository basis. Understandably so. Further, the idea that risk-based capital standards should be applied equally to all depository institutions has no more validity than the notion that 18,000 increasingly deregulated, and increasingly heterogeneous banks and S&Ls can be effectively supervised under a uniform set of regulations.

Before any legislation authorizing risk-based capital is written, I suggest the following -- (1) the advocates of risk-based capital should clearly and specifically demonstrate why risk-based capital is superior to risk-sensitive premiums and (2) they should show why it will be easier to implement a risk-based capital determination formula than a risk-sensitive pricing formula.

Q7 - In 1981 and 1982, the banks and thrifts were suffering from disintermediation - their better customers were flocking to money market funds in droves. Now the concern seems to be that the higher quality loan customers are able to fill their needs elsewhere. The banks point to commercial paper, and the securitization of their loan portfolio. They claim that this trend is being caused in part by their capital ratios and reserve requirements. What is your view? What recommendations do you have for us in this area?

Capital ratios and reserve requirements, or rather the lack of interest paid on mandatory reserves banks deposit with the Federal Reserve, add to the other costs banks must recover in order to lend, or intermediate funds, profitably. Because existing capital ratios and reserve requirements ignore the credit worthiness of bank borrowers, capital and reserve costs (i.e. foregone interest income), in terms of basis points per dollar lent, are essentially the same no matter

how high or low the borrower's risk. High quality credits have other sources of funds, specifically commercial paper and loan portfolio securitization that operate with lower capital ratios (i.e. with higher leverage) and free from any reserve requirements. Therefore, all other costs being equal, commercial banks have higher lending or intermediation costs, for comparable quality credits, than do other sources of funds. In some, but not necessarily all cases, this cost differential shifts intermediation activity away from banks and towards other sources of funding, specifically commercial paper, portfolio securitization and other forms of debt. In some circumstances, though, banks would still not be cost effective even if they were playing on a level playing field. It certainly is safe to say, though, that unnecessarily high capital ratios and non-interest bearing reserve requirements do not work to the advantage of the commercial banking industry.

With regard to recommendations, the first one is easy -- the Fed should pay a market rate of interest on the reserves banks are required to place with it or, alternatively, Congress should permit banks to place their required reserves with whatever FDIC-insured depository institution pays the highest interest rate.

The second recommendation -- dealing with capital ratios -- requires some background discussion that goes back to closely related subject matter discussed in the previous answer -- the interaction between banking risk and capital levels. Regulatory policy has increasingly emphasized more uniform, and higher, capital levels for banks. The opposite has, in reality, occurred for S&Ls. As banking <u>industry</u> risk has been perceived to have increased in recent years, <u>uniform</u> capital requirements have been increasingly enforced even as the range of riskiness among individual banks has probably widened. In effect, a uniform level of risk has been assumed for all banks, with the consequence that the cost of risk-taking (the cost of required equity capital) has been made more uniform. This, in turn, has lessened the cost competitiveness of banks attempting relatively low risk lending with the further consequence that the entire banking industry is being driven by higher capital requirements to pursue even riskier lending. It should come as no surprise that banks have become increasingly less competitive as suppliers of funds to low risk credits. One could even argue that it has been conscious public policy to steer banks towards higher risk lending, and consequently, away from lower risk lending.

All of this discussion brings me back to this question: how can banking regulation, which now focuses increasingly on protecting the deposit insurance funds, best accommodate the growing diversity and heterogeneity of banking institutions? Very simply, classic banking regulation, with uniform rules for all, simply can not accommodate much diversity. Risk-based capital or, preferably, risk-sensitive premiums can. However, risk-based capital/risk-sensitive premiums are pricing devices; by definition, prices can only be set in a marketplace that by definition has many buyers and many

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sellers. While there are now many buyers for depositor protection (be it insurance or adequate equity capital), there unfortunately is only one seller -- the depository's federal deposit insurer and/or the regulator who sets capital ratios.

Until there is a private marketplace where depositor protection can be purchased in a competitive, risk-assessing atmosphere, there will be no satisfactory answer. In effect, the banking industry and public policy makers will just have to live with the fact that (1) banks will increasingly lose market share for lower risk credits to other sources of funds and (2) foreign banks will continue to gain market share at the expense of American banks.

Q8 - With regard to the concern that some states may have expanded bank product authorities beyond what may be prudent, can this issue be dealt with by giving the federal insurance agencies the authority to require a prudent level of capital to support the activity in order to maintain insurance - rather than giving any federal agency the authority to override a state legislature? In other words, wouldn't the adoption of risk-based capital standards go a long way toward solving this problem?

The states should be reminded of one very important fact of government life -- he who insures, regulates. This is becoming increasingly true as non-safety-and-soundness regulations fade away. As stated above, as regulation becomes increasingly focused on protecting the deposit insurance funds, it becomes increasingly reasonable to argue that the guy who pays is the guy who sets the rules. As long as the states want the federal government to provide deposit insurance for state-chartered S&Ls, the states are going to have to live with Federal regulations that attempt to protect FSLIC.

The above, though, is not a brief for risk-based capital standards. Government-set, risk-based capital standards are no more feasible for state-chartered S&Ls than they are for community or multi-national commercial banks. Thus, there will be no easy answer for accommodating the vast range of riskiness found among state-chartered S&Ls until such time as a private marketplace for deposit insurance can be instituted. Until that occurs, there will be no satisfactory solution to this problem; to chase after one will be about as successful as trying to capture a will-o'-the-wisp.

Q9 - Even though the FDIC continues to grow, how can or should we determine if the size of an insurance fund is sufficient and will continue to be sufficient?

The FDIC is not an insurance company and the size of its "insurance fund" has to date borne no actuarial relationship to its risk exposure. It can and it should. I will discuss below how the adequacy of the FDIC's fund balance, or "policyholders' surplus," to use insurance industry parlance, should be evaluated.

First, the FDIC should adopt insurance industry accounting principles, called statutory accounting, which are much stricter than government accounting standards or even Generally Accepted Accounting Principles (GAAP) in calculating "policyholders' surplus," or the FDIC's fund balance. The most significant consequence for the FDIC of adapting statutory accounting is that the FDIC would have to fully reserve for losses it can reasonably expect in banks it has closed as well as for future insolvency losses in banks that are still operating. These anticipated losses are known as IBNR -- Incurred But Not Reported. For the last three years, the National Credit Union Share Insurance Fund (NCUSIF) has reflected IBNR on its balance sheet. Unfortunately, the FDIC and the FSLIC have not. Quite possibly, the FDIC is also carrying as assets salvage and subrogation rights from failed banks that do not qualify as assets under statutory accounting principles.

The FDIC reported a deposit insurance fund balance of $17.2 billion as of December 31, 1984. That balance will probably grow to about $19 billion by the end of 1985. My very rough estimate is that under statutory accounting, the FDIC's policyholders' surplus at the end of 1984 would have been roughly half its fund balance, or roughly $8 to $10 billion.

Second, upon restating the FDIC's fund balance, or policyholders' surplus, in accordance with statutory accounting principles, the adequacy of its surplus must be measured in light of several insurance industry standards. One of the most common measures is the relationship of annual premiums to surplus, with the rule-of-thumb ratio ranging from 2-to-1 to 3-to-1. Given that the FDIC should have had over $2 billion in premiums last year, had it properly reserved for its losses in the Continental Illinois situation, application of a 2 to 1 ratio would indicate that the FDIC needs a policyholders' surplus of approximately $1 billion, or substantially less than the $8 to $10 billion it would probably report under statutory accounting principles. This excess, however, is not sufficient to cover the FSLIC's looming insolvency losses.

The fact that the FDIC does not reinsure any of its loss exposure probably creates the need for a larger policyholders' surplus than would be the case if the FDIC did reinsure some portion of its larger risks. However, as stated above in the answer to Question 1, a deposit insurer should never take any losses, particularly if it moves fast enough to assume control of a bank before it becomes insolvent. This should be particularly true for large banks since they, like battleships, sink very slowly, over a number of years. Furthermore, these large banks are favorable candidates for recapitalization, with private sector monies, because of their going concern value. Therefore, FDIC losses in a large bank failure should be small relative to its total deposits, as Continental showed. According to the GAO opinion on the FDIC's 1984 financial statements, the FDIC stands to lose from $551 to $774 million on the loans it has acquired from Continental. Those amounts approximate 2% to 2 1/2% of Continental's total deposits at the time its run

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started. Because of the FDIC's lack of reinsurance, its reserves should equal some percentage of its largest individual risk and a lower percentage of some combination of large risks. Due to a lack of data, I am unable to state what those percentages should be. However, I do think the application of these percentages would indicate that the FDIC can safely operate with a lower policyholders' surplus than current data indicates it to be.

You will note that I have made no reference to the ratio of the FDIC's reserves to the total amount of its insured deposits (1.23% at the end of 1984) or to total deposits in insured banks (.95% at the end of 1984). These ratios, while used throughout the deposit insurance industry, are not relevant because they bear no relationship to the FDIC's loss history, IBNR, largest individual risk, distribution of risks, or implicit total risk exposure.

In considering the fund size question, it is worthwhile investigating past rationales for setting the size of the fund. My research assistant, Ms. Laurie Skwerer, has combed the extensive papers of the late Clark Warburton, an FDIC economist for several decades, looking for such rationales. His papers are now in the Special Collections Section of the George Mason University Library. Perhaps the most succinct document Ms. Skwerer found on the fund size question is testimony presented to a Senate Banking subcommittee on February 14, 1957 by Mr. Henry E. Cook, then chairman of the FDIC. Mr. Cook's testimony concluded that "... a reserve fund amounting to 1 percent of the deposits in insured banks is the smallest figure that can possibly be considered reasonably adequate in view of the Corporation's responsibilities." This recommendation contrasts with a .95% fund size at the end of 1984. Mr. Cook's testimony also contains very detailed analyses supporting several plausible fund size targets. A close study of this testimony reveals crucial assumptions that fail logical and historical analysis. A reexamination of the Cook testimony, as well as other papers on optimal fund size, could lead one to conclude that the FDIC can very safely operate with a much smaller fund balance than heretofore has been thought possible.

I will merely summarize the flaws in the Cook testimony as this subject warrants a much more detailed treatment than can be set out here.

One, Cook, in basing his 1% recommendation on the FDIC's "disbursement" needs, confused the funding of failed bank transactions, the disbursement process, with the actual insolvency loss incurred in those failed banks. To support his recommendation, Mr. Cook presented a hypothetical federal deposit insurance fund for the years 1900 to 1930. This hypothetical fund assumed that disbursements in failing bank situations would equal 50% of the deposits in the commercial banks that actually failed in those years. This accords fairly well with the FDIC's 47% disbursement rate through 1984. Disbursements, however, are not an expense; they represent the acquisition of failed bank assets and claims on which there almost always is some, if not substantial,

recovery. Disbursements, which in effect are short-term investments, could largely if not totally be financed by borrowings from the U. S. Treasury or other sources. They do not have to be, and should not be, 100% financed by loss reserves. Consequently, Cook's recommendations ignored the fact that deposit insurance reserves are largely needed just to absorb actual insolvency losses in excess of losses covered by current premiums. In effect, insolvency losses are disbursements that are never recovered.

Mr. Cook's fund anticipated insolvency losses and fund expenses equal to 51% of anticipated disbursements. For the FDIC's entire existence, its insolvency losses and fund expenses have equaled 43% of disbursements. Pure insolvency losses also differ between the Cook model -- 24.3% of total deposits in failed banks -- and the FDIC's long-term experience -- 13.7%. One reason for this insolvency loss difference may be the fact that most banks failing before 1934 were liquidated while most failures since then have been merged through purchase and assumption transactions that are less expensive to depositors, and thus to their insurer, than are liquidations. For whatever reason, the FDIC's target fund balance will be substantially overstated if it is based on disbursements and not actual insolvency losses.

Two, the Cook analysis assumed that the existence of deposit insurance during the 1900-1930 period would not have reduced bank failures and insolvency losses one penny. This assumption directly contradicts the entire rationale for deposit insurance and the FDIC's experience. Thus, it is very unwise to calculate a target FDIC fund balance on pre-FDIC numbers unadjusted for the significant, positive impact of deposit insurance.

Three, the Cook analysis ignored the changes in banking structure that occurred from the 1920s to 1957 nor could it have considered the even more significant technological and structural changes that have occurred since 1957. Any calculation of a suitable fund balance for 1985 and beyond must take these changes into account. In my opinion, these changes, particularly the increase in the average real size of banks and the spread of branch banking, have greatly increased the ability of individual banks to survive economic adversity. In other words, more banks today are capable of surviving the economic conditions of the 1920s and 1930s than were the banks of those years.

Four, the Cook analysis inadequately addresses the twin primary causes of banking failure and large insolvency losses in the twenties and early thirties -- the everwidening price deflation of that era coupled with the Federal Reserve's total inability to function as a lender of last resort. This inability fostered even more price deflation. Price deflation leads to bank insolvency, failure, and thus to depositor losses for one very simple reason -- deflation drives down nominal (i.e. dollar-denominated) asset values while nominal liabilities remain unchanged. A deflationary decline in a bank's asset values first wipes out its equity capital and then impairs its deposit liabilities until such

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time as the bank is declared insolvent and then acquired or liquidated, with further insolvency losses.

The 1930-33 period illustrates this point most dramatically -- depositor losses in failed commercial banks averaged 19.6% of deposits as prices declined 23%, in large part because the Fed permitted the money supply to plunged 33%. Surely the number of bank failures during the 1930-33 period, and the amount lost by depositors in those failed banks, would have been far less had the price level remained constant during those years. During the 1921-29 period, when the overall price level was essentially flat (although the agricultural sector experienced significant price deflation), annual depositor losses in failed banks totaled just one-fifth the 1930-33 average. On this basis alone, one can argue that most depositor losses during the 1930-33 period occurred because of price deflation, not bank insolvency per se. In my opinion, it would be bad public policy to set the FDIC target fund balance on the assumption that the Fed will permit a massive price deflation to exacerbate FDIC insolvency losses. In effect, the Cook testimony made that assumption. I hope that assumption will not be made when the size issue is revisited.

As the banking committees address the fund size question, perhaps they should seek opinions on the appropriate size of the FDIC insurance fund from insurance industry accounting and actuarial specialists who would evaluate the FDIC as if it were a real insurance company operating in an environment where the Fed performed properly as America's lender of last resort.

Q10 - In your opinion, what are the advantages and the disadvantages of risk-based capital and risk-based premiums? Should we consider one or the other or both? Why?

See answer to Question 6.

Q11 - Would you comment on the recently passed Texas law setting up a supplemental fund to indemnify FSLIC from additional risks incurred by state associations exercising expanded state powers?

I do not have detailed knowledge of the Texas Supplemental Fund (TSF), but I will list some concerns about it that I believe should be addressed in greater detail before FSLIC places any reliance on it.

First, the TSF will apparently be capitalized solely by monies from its member S&Ls, who in turn will be able to treat their TSF investments as assets. This is precisely the type of capitalization the private S&L deposit insurers had in Ohio and Maryland. This type of capitalization is also what tipped so many Ohio and Maryland state-insured S&Ls towards or into insolvency after the failure of their insurers made the insurance fund deposits of the surviving S&Ls worthless, and thus a writeoff against their capital.

Second, the TSF does not appear to have the explicit guarantee of the State of Texas, which probably means that if the TSF fails, FSLIC will be left holding the bag to the extent that TSF's assets are insufficient to cover the asset values it has insured.

Third, the TSF authorization legislation limits TSF assistance to any one S&L to the lesser of 10% of the total member deposits in TSF or 20% of the S&L's "admitted" assets as of the end of the previous calendar year. The 10% limitation would tend to limit TSF assistance to a large, failing S&L to substantially less than 20% of that S&L's assets.

Fourth, and perhaps most serious, the TSF's Plan of Operation (Sec. V-C, fourth paragraph) states: "The (TSF) shall obtain preferential lien treatment when it grants assistance in impaired association workout situations." It appears that these liens would have the effect of passing through to the FSLIC all losses in asset values that would occur in an S&L that fails. If this is true, then this lien provision appears to totally defeat, from an FSLIC perspective, the intent of the TSF.

Date submitted:

November 1, 1985

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DEPOSIT INSURANCE REFORM AND RELATED SUPERVISORY ISSUES

PART I

TUESDAY, SEPTEMBER 10, 1985

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, D'Amato, Gorton, Mattingly, Hecht, Proxmire, Cranston, Dixon, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

I am happy today to resume the hearings of this committee on the subject of deposit insurance reform. We commenced them in July of this year and had some very good hearings during that month. We were informed of the viewpoints of the regulators in most of those hearings. We also had different securities analysts and economists present. These are people who have wrestled with the need for modification of the deposit insurance scheme over a long period of time and their opinions need to be afforded great weight.

Today, the groups that are most immediately affected will be heard. I have said before that I come to the issue of deposit insurance reform with few preconceptions. I admit I have some, but few.

The marketplace has changed. Indeed, the number of problem institutions has grown substantially and yet the vast majority of financial institutions are healthy.

These hearings are intended to determine what legislative changes need to be made to adopt supervision and deposit insurance to the present circumstances. There are any number of ways this can be accomplished and I am not wedded to any particular method. However, as a matter of principle, we should examine the whole range of possibilities, including risk-based capital, risk-based premiums, rebates related to risk, and all the myriad combinations of these options.

Our invitations to witnesses for this series of hearings have been unusual in that they asked the witnesses to address problems rather than comment on a particular proposal. I thank the witnesses for their efforts to think these problems through, and for

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giving us the benefit of their objective opinions. This forthrightness will help our committee to analyze all of the possibilities rather than choosing among a limited number of options.

The House Banking Committee is also starting hearings on deposit insurance reform today. The possibility of a joint legislative initiative with the House of Representatives is quite intriguing. I am mildly optimistic that this fortuitous scheduling of both committees holding hearings at the same time will foreshadow agreement on some form of deposit insurance reform.

I want to welcome the witnesses and thank them for taking their time to share their views with us. We will have two panels of witnesses today. The first panel will include Chip Backlund, president of the Independent Bankers Association, and president of the Bartonville Bank in Peoria, IL; James Cairns, the president of the American Bankers Association, and president of Peoples National Bank of Washington in Seattle, WA. The second panel will include Kenneth Albers, chairman of the National Council of Savings Institutions; and chairman of Provident Savings Bank in Jersey City, NJ; Gerald Levy, vice chairman of the U.S. League of Savings Institutions; and president of Guaranty Savings, Milwaukee, WI.

Gentlemen, your entire statements will be printed in the record as if read. We would appreciate it if you would summarize your statements. We will have all of you speak prior to members of the committee asking you questions. The committee would reserve the right to have you respond to questions in writing.

Senator Mattingly, do you have any opening comments you wish to make?

Senator MATTINGLY. No, Mr. Chairman, I have no opening comments. I will have questions for the record later, though.

The CHAIRMAN. Senator Cranston.

Senator CRANSTON. I have no statement. I welcome the witnesses and I thank you, Mr. Chairman, for holding this hearing.

The CHAIRMAN. Senator Hecht.

Senator HECHT. No statement.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Mr. Chairman, I would ask leave to put an opening statement in the record.

STATEMENT OF SENATOR ALAN DIXON

Mr. Chairman, I am pleased to be here this morning as the Banking Committee continues its series of hearings on deposit insurance issues. We have a distinguished group of witnesses from the banking and thrift industries before the committee today and I look forward to their testimony.

I am particularly pleased to see that my good friend and distinguished Illinoisan, Chip Backlund, president of the Independent Bankers Association of America, is among those testifying today. His testimony is always informative and well thought out.

The issues he and the other witnesses will address are extremely important and just as complex. Deposit insurance is at the heart of the Federal Government's involvement with depository institutions. While changes in the existing deposit insurance scheme may be necessary, however, great care must be taken to ensure any

changes that may be made do not undermine the enormous good that the deposit insurance merchanism has accomplished.

As I have stated before, I come to these hearings with an open mind. I understand the desire to try to build greater market discipline into the system. I appreciate the need to make sure that all banks from the largest to the smallest are treated fairly, equitably, and without bias. I also appreciate the concerns of many thrifts and banks regarding the separate insurance funds of those two industries. I'm sure the testimony of today's witnesses will be of great benefit to the committee in its examination of these and other deposit insurance issues.

I want to express my personal pleasure at seeing my old friend, Chip Backlund, president of the Independent Bankers Association of America, from the Bartonville Bank of Peoria here in the committee this morning.

The CHAIRMAN. Thank you.

Mr. Backlund.

STATEMENT OF B.F. "CHIP" BACKLUND, PRESIDENT, INDEPENDENT BANKERS ASSOCIATION OF AMERICA; PRESIDENT, BARTONVILLE BANK, PEORIA, IL

Mr. BACKLUND. Thank you, Mr. Chairman. I will summarize the written remarks.

I appreciate this opportunity to be here this morning and I commend this committee for recognizing the need for deposit insurance reform. In my opinion, these hearings are long overdue.

It would not be an overstatement to say that deposit insurance is the rock upon which this Nation's financial structure is built. Since the Great Depression, the FDIC shield has served as an emblem of confidence that every bank depositor recognizes and depends upon. For 50 years this system has worked well, but under the strain of recent bank failures it makes these hearings most timely.

NEED TO KEEP BOTH FUNDS INDEPENDENT

While I understand that these hearings will also address issues related to the FSLIC fund, we should be most careful to maintain the independence of these two funds. The IBAA strongly supports maintaining the unique character of the savings and loan industry in meeting this country's housing needs. But as long as fundamental functional and structural differences exist between commercial banks and thrift institutions, a merger of the FSLIC and the FDIC funds would be harmful to both industries and the public.

This morning I would like to limit my oral remarks to two key areas. One, what is the proper role of the Federal Deposit Insurance Corporation? Two, what regulatory action should the FDIC take to limit its own liability and install market discipline among commercial banks?

In order to deal with the first issue, we must go back to the beginning, to 1933, and reexamine certain basic principles in the existing Federal Deposit Insurance System. First and foremost, deposit insurance was created out of the trauma of the Depression. Its central principle continues to be that deposit insurance should pro-

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vide a floor of minimal federally guaranteed protection for every depositor of an insured institution.

Second, the FDIC was created by Congress to assist in the orderly closing of federally insured banks that fail and to assure that these closings are handled in a fair and efficient manner.

It is the second principle—the limited nature of Federal deposit insurance—that has been seriously eroded. Within the past 18 months we have witnessed the development of a de facto two-tiered banking system in which one of the Nation's largest banks, Continental Illinois, essentially failed. Yet none of its uninsured depositors or even its creditors lost a nickel.

During this same period, more than 20 smaller FDIC-insured banks failed in which uninsured depositors did lose a significant amount of their deposits.

To put it bluntly, the element of fairness is disappearing from our deposit insurance system. As the former Comptroller admitted last year, we now have reached the point where some banks are simply too big to fail. The reverse of this is also true. Many community banks are too small to save.

We did not hear any talk of modified payouts or market discipline when Continental failed. In fact, such options were never even considered. Where is the market discipline for the Continental-sized bank?

It is not hard to see the kind of impact that Continental is having on the marketplace. If you are a depositor today and want to make a large deposit, where would you most likely go? To a bank the size of Continental or one the size of the Bartonville Bank? How can we say that it is fair for one uninsured depositor to be made whole and another one not? Can we financially afford to protect all large banks from failing?

Please do not misinterpret my remarks. What I am saying is that all uninsured depositors over $100,000 should be treated similarly, if not equally. The FDIC Chairman recently suggested that Congress should provide for a fixed minimum percentage to be paid on funds over $100,000 to depositors in all bank failures. Some approach of this type is needed in order to prevent the perversion of our deposit insurance system into a welfare program for the country's largest banks.

IBAA'S PROPOSAL

Granted, this is not an easy problem to solve. But IBAA offers the following suggestions to the committee.

First, that the basic $100,000 coverage be continued.

Second, that the basic concept behind the modified payout—that is, that large depositors over $100,000 should bear some degree of market risk in all bank failures—be applied to all bank failures, both large and small, and to de facto failures like Continental.

Third, that a system of risk-based premiums be instituted consisting of two components. The first component would be correlated to a bank's unique financial condition as established by a system similar to the CAMEL rating system. The second component would be based upon the systemic risk that the bank poses for the fund. This factor would be measured by the potential draw that a bank

could make upon the fund's resources in the event of the bank's failure. Such an approach would necessarily include assessments based upon foreign, as well as domestic deposits, and on off-balance sheet liabilities.

Mr. Chairman, while the IBAA supports the concept of risk-based premiums, Congress' first priority should be to protect the fund against the virtually unlimited liability posed by large bank failures and to restore a sense of fairness to the system.

Fourth, in making these various reforms, Congress should address the politics and management of the Federal bank regulatory agencies. We recommend that the FDIC Board of Directors be expanded to at least five members and should consist of individuals representing a broad spectrum of the industry and who have hands-on banking experience. At least one Director should understand in depth the Nation's small community banks. The terms of Directors should be staggered and of sufficient length to provide continuity and less political involvement.

The appointment in recent years of cheerleaders for administration policy has proved very disruptive to our financial system. Banking laws should be changed by Congress, not by appointed bank regulators.

My personal contention is that a major contributing cause of the current problems in the insured financial system is the failure of the regulators to adequately police and identify problem institutions early on and to anticipate future problems and risks. That's why, in my view, regulators need extensive banking experience.

The second area I would like to discuss this morning is the FDIC's recent efforts to limit its potential insurance losses through regulation.

The FDIC's main regulatory effort to reduce losses and instill greater market discipline has involved brokered deposits. In general, we support Chairman Isaac's efforts to limit the indiscriminate access by banks to hot money by denying deposit insurance for brokered funds. We do not believe that these deposits—which are generally large CD's broken up into $100,000 chunks—are entitled to the same protection that was designed for small depositors.

Unfortunately, several of the agency's other proposals would be far less effective. First, the FDIC has proposed that all banks be required to maintain total capital of 9 percent, with up to 3 percent allowed in subordinated debt.

While we support insured banks maintaining healthy capital levels, subordinated debt poses serious problems for smaller banks. It just is not a viable vehicle for community banks to raise subordinated capital. There is little, if any, market and the cost associated with issuing public issuances are too high for the smaller bank.

In addition, a flat 9-percent rule is too simplistic. Acting Comptroller of the Currency, Joe Selby, indicated that his office is considering a more sophisticated risk-based approach which would take a number of risk factors into account, including off-balance sheet activity. The IBAA strongly recommends that the regulators consider such a broad-based approach before moving ahead.

Likewise, we are disturbed by the FDIC's proposal to require increased disclosure of financial information and enforcement actions taken against banks by the FDIC. While such a measure theoreti-

cally would install greater market discipline, these proposed rules would harm both poorly managed and well managed institutions.

First of all, smaller institutions are more often the target of formal regulatory actions simply due to their size and their lesser capacity to defend themselves. Such a regulation would result in a false public perception that smaller institutions are somehow less safe than larger ones.

In addition, financial information is currently available to the public and is sufficient for most investors to evaluate a bank's condition.

Furthermore, the Office of the Comptroller and the Federal Reserve are not requiring the same degree of disclosure, so it would be discriminatory.

In conclusion, Mr. Chairman, we look forward to working with the committee in fashioning deposit insurance reform which treats all institutions and depositors fairly, encourages the greatest possible degree of market discipline, and avoids excessive Government regulation.

Thank you.

[The complete prepared statement follows:]

T E S T I M O N Y O F

B. F. (Chip) Backlund

President

Independent Bankers Association of America

Mr. Chairman and members of the Committee. My name is B.F. (Chip) Backlund and I am president of the Independent Bankers Association of America (IBAA), a national trade association representing 7,500 commercial banks throughout the nation. I also serve as president of the Bartonville Bank, a $36 million bank near Peoria, Illinois.

I appreciate the opportunity to participate in this morning's hearings. The Committee is to be commended for recognizing the need for deposit insurance reform. In my opinion, these hearings are long overdue.

Mr. Chairman, it would not be an overstatement to say that deposit insurance is the rock upon which this nation's entire financial system is built. Since the Great Depression, the FDIC shield has served as an enduring emblem of confidence that every bank depositor recognizes and depends upon. It has stood for the simple proposition that in the event of a bank failure, all depositors will be fully protected up to $100,000 on their deposits. For 50 years, this system has worked extremely well, even under the recent strain of a record number of bank failures.

As we all know, the FDIC today is facing an exceptional strain in the form of at least 100 bank failures anticipated

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by year's end. While we are fully confident that the FDIC fund is healthy and will continue to be able to withstand any bank failure in the foreseeable future, it is appropriate that Congress should take time to reexamine the Federal Deposit Insurance Act and to take steps to strengthen it and render it more efficient and equitable for all bank depositors.

While I understand that these hearings will also address issues related to the FSLIC fund and problems in the thrift industry, we should be most careful to maintain the independence of these two funds. The IBAA recognizes and strongly supports maintaining the unique character of the savings and loan industry in meeting this country's housing needs. As long as fundamental functional differences exist between commercial banks and thrift institutions, the insurance needs and capabilities of the two industries will differ. In our view, a merger of the FDIC and FSLIC funds would be harmful to both industries and to the public.

Because deposit insurance is the foundation of our modern banking system, it is difficult to speak of deposit insurance reform without addressing some of the most basic questions about our financial system. Who should be protected by deposit insurance--all depositors or just small ones? When and how should a bank be permitted to "fail"? How much

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risk should the FDIC bear-- and how much discipline should the market provide?

We understand that these hearings will cover an extremely broad range of issues--and they should. However, this morning, I would like to limit my remarks to two key areas:

1) What is the proper role of the federal deposit insurance fund?

2) What actions can and should the FDIC take to limit its own liability and to instill greater market discipline among commercial banks?

The first of these issues is easily the most important and also the toughest. In order to deal with it, let's go back to the beginning--to passage of the original Banking Act of 1933--and re-examine certain basic principles in the existing deposit insurance system.

What are those principles?

First and foremost, deposit insurance was created out of the trauma of the Depression. Its central principle was--and continues to be--that deposit insurance should provide a floor of minimal, federally guaranteed, protection for every

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depositor of an FDIC-insured institution, up to a certain limit. Congress has set this amount at $100,000 per customer. This ceiling--a "safety net", if you will--has worked well in maintaining customer confidence and preventing "runs" on financial institutions. Depositors have come to know and rely upon this $100,000 limit, and it should be retained.

Second, the FDIC was created by Congress to assist in the orderly closing of federally insured banks that fail and to assure that these closings are handled in a fair and efficient manner. It was not designed to protect banks from the possibility of failure. As the Senate Report to the original 1933 Act states:

> ....The great number of banks now in the hands of receivers has created a situation in which a very large number of persons are unable to meet their obligations and in which many business houses are embarrassed through inability to get the use of their funds.....In order to provide against a repetition of the present painful experience in which a vast sum of assets and purchasing power is 'tied-up', we have recommended the creation of a Federal bank-deposit insurance Corporation to liquidate the assets of closed member banks.....to insure the time and demand deposits of such banks.....

(S. Rep. No. 73-77,73rd Cong., 1st Sess.11 (1983)).

In other words, the FDIC was designed to promote the stability of the banking system and to prevent depositors' funds from being "tied-up" indefinitely. The FDIC, as receiver for failed banks, should act to protect the small

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depositor. The fund was never designed to protect all depositors or to prevent banks from failing.

It is this second principle-the limited nature of federal deposit insurance-that has been seriously eroded during the past several years.

Within the past 18 months, we have witnessed the development of a de facto two-tiered banking system, in which one of the nation's largest banks, Continental Illinois, "failed", yet none of its uninsured depositors lost any of their deposits. During this same period, more than 20 smaller FDIC-insured banks failed, in which uninsured depositors lost significant amounts of their deposits, either through straight liquidation or what the FDIC termed a "modified payout" experiment. Under this procedure, the failed banks were acquired by other institutions through a transfer of insured deposits, but uninsured depositors were treated the same as if the banks had been liquidated. (A chart of these failures is attached as Appendix A.)

To put it succinctly, the element of fairness is rapidly disappearing from our deposit insurance system. As the former Comptroller of the Currency, C. Todd Conover, admitted last year at the Continental hearings, we have now reached the point in this country where some banks are "too big to fail". The reverse of this is also true, as

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demonstrated by the use of the modified payout in smaller-sized banks; many community banks are "too small to save." We did not hear any talk of "modified payouts" or "market discipline" when Continental failed. In fact, such options were never even considered. As the FDIC's 1984 Annual Report stated, "Permitting Continental to fail and paying off insured depositors was never a feasible option for the regulators."

It is hard to overstate the long-range significance of this new system. On the one hand, the federal government has, in effect, announced that it will not only fully insure all deposits at the nation's largest money center banks, but these banks' other general creditors as well--a tremendous obligation by anyone's standards. On the other hand, the "modified payout" experiment demonstrates that the concept of market discipline, so cherished by the FDIC, is only being applied to institutions too small to save. Where is the market discipline for the Continental-sized banks?

Until recently, most bank failures have been handled through 1) FDIC-assisted mergers, 2) purchase and assumptions, or 3) straight liquidations. In the case of mergers, the acquiring institution acquires all deposits of the failed bank and therefore all uninsured depositors are made whole. In purchase and assumptions, the acquiring bank purchases the assets and assumes the liabilities of the

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failed bank, often with FDIC assistance, but all uninsured depositors are still made whole. In liquidations, on the other hand, all insured depositors are immediately paid off by the FDIC and the uninsured depositors stand in line with all other unsecured creditors and recover whatever monies the FDIC is able to collect over the several years needed to liquidate the bank.

A fourth alternative was initiated on July 8, 1983, with the failure of the Union National Bank of Chicago. The FDIC began a procedure called a "modified payout" or "deposit transfer," which is a hybrid between a P&A and a liquidation. In the Union National Bank, the FDIC transferred all insured deposits to the acquiring bank, Seaway National Bank of Chicago, but did not transfer the $1.5 million in uninsured deposits. In effect, this put uninsured depositors in the same position as if the bank had been liquidated. (In some cases, the FDIC has cushioned this loss by making an "advance payment" to depositors for that portion of the uninsured deposits which the agency expects to recover eventually, rather than making them wait, as in a straight liquidation.)

Contrast this situation with what happened last year at Continental. In that case, a liquidation was clearly impossible, since the approximately $25-35 million in uninsured deposits far outweighed the $4 million in insured

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deposits. However, rather than using some form of modified payout as in other recent bank failures, the FDIC, in effect, became the conservator of the bank and made all creditors whole, including uninsured depositors. The FDIC, meanwhile, will undoubtedly suffer substantial losses which may well exceed the cost that would have been incurred through some form of modified payout.

It is not hard to see the kind of impact that Continental is having on the marketplace. Let me ask you: If you were a depositor today and wanted to make a large deposit (e.g. $300,000) in a safe place, where would you be more likely to go--a bank the size of Continental Illinois or one the size of Union National? Most likely, you would go where you would get 100% insurance coverage--i.e. Continental Illnois. How can we say that it is fair for one uninsured depositor to be made whole and another one not? On whom should the risk of failure fall--the Chicago depositor who puts his money in Union National or the Japanese depositor who wires his deposit to Continental? Why should only the small banks face the risk of failure?

Please do not misinterpret my remarks as suggesting that I am opposed to the action that was taken by the FDIC to save Continental or, conversely, that the FDIC should guarantee all uninsured depositors of small banks. What I am saying, to the contrary, is that all uninsured depositors over the

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$100,000 limit should be treated similarly, if not equally. We must re-shape the FDIC so that depositors over the $100,000 threshold in the large bank failure situations will always suffer some degree of loss.

Even the FDIC, I think, recognizes that the fairness issue is real and serious. Chairman Isaac of the FDIC testified before this Committee on July 23, that Congress should address this fairness question directly. According to Isaac,

> .... There is the question of how bank failures can be handled so as not to discriminate or give the appearance of discriminating against smaller banks.... To remove the uncertainty regarding the distribution of uninsured depositors, for example, Congress could provide that a fixed minimum percentage be paid -- say 80 to 90 percent of funds over the $100,000 limit. A number of variations on this theme are possible.

Congress, he said, should consider building upon the agency's experience with the modified payout experiment in smaller banks. We support Mr. Isaac's proposal and contend that it is needed in order to prevent the perversion of our deposit insurance system into a welfare program for the country's largest banks.

The idea of extending the modified payout to large bank failures has also been discussed by the Working Group of the Cabinet Council on Economic Affairs in its report on deposit insurance reform issued in January 1985. The report stated:

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> Prospective advantages of this proposal include the potential for increasing creditor discipline and the fact that loss sharing would permit a large bank or thrift to be merged with less cost to the insurance corporation. In addition, consistent use of the 'haircut' approach would eliminate the inequity of the status quo wherein large institutions are afforded de facto 100 percent coverage for uninsured creditors because a liquidation is not deemed feasible, while only the uninsured creditors of smaller insitutions are subject to a liquidation and potential loss.

(Report, pp 47-48. For the IBAA's comments on the Working Group's study, see Appendix B.)

In our opinion, the Working Group raised an extremely important point by talking about the cost savings inherent in these "haircuts", but then shied away from taking a position on whether such a procedure would be cost-effective. We think it would be.

We recognize that this is not an easy problem to solve. Our bank regulators need to take very seriously the ruinous impact that money center bank failures could have on the nation's payment system and our economy--including smaller banks and thrifts. Although the IBAA does not have a comprehensive solution to the "too big to fail" problem at this time, I would like to offer the following suggestions to the Committee:

First - That the $100,000 coverage limit for all depositors is basically sound and should be retained.

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Second - That the basic concept behind the "modified payout"--i.e., that large depositors over $100,000 should bear some degree of market risk in all failures--is essentially fair and workable, provided that it is applied to all bank failures, both large and small, and to de facto failures like Continental. I suggest that this Committee formally request the FDIC to provide it with a set of legislative and regulatory alternatives for extending the modified payout concept to all bank failures. Until such time as this "experiment" applies across-the-board, it should be terminated.

Third - That a system of risk-based insurance premiums be instituted, consisting of two components.

The first component would be correlated to a bank's unique financial condition, as established by a rating system similar to the present CAMEL rating system. The second component would be based upon the systemic risk that a bank poses for the deposit insurance fund as a whole. This factor would be measured by the potential draw that a bank could make upon the fund's resources in the event of the bank's failure. In short, the bigger the risk that an institution poses to the fund's resources, the higher its premiums should be.

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Such a systemic approach would necessarily include assessments based upon foreign, as well as domestic, deposits. As FDIC Director Irvine H. Sprague stated recently in an excellent speech on this issue:

> While the assessment rate has been essentially unchanged in statutory amount since our beginning over 50 years ago, the total liabilities and funds generation apparatus of banks have undergone significant change. One example: deposits payable at foreign branches of American banks represent a money-gathering mechanism whose proceeds, like any other liability, can be invested in assets which can lead to problems when they depreciate in value. However, they entirely escape the deposit insurance premium.
>
> For example, BofA paid us almost $40 million in assessents in 1984, whereas Citibank paid $18.5 million. Both, in my opinion, enjoy de facto 100 percent insurance protection, but BofA, with less total book liabilities, paid more than twice as much in insurance assessments. Neither paid in proportion to the assessments on smaller banks which rely completely on domestic deposits. (emphasis added)

These foreign deposits, when coupled with the other off-balance-sheet liabilities such as standby letters of credit, interest rate swaps, and loan sales recourse, pose tremendous systemic risks which should be factored into the assessment premium schedule. By varying rates through the use of these two components, insurance premiums for individual banks would be adjusted in accordance with both their unique financial condition and the size and range of banking activities in which they engage.

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Mr. Chairman, a great deal of the testimony at these hearings has been devoted to risk-based insurance premiums; they have been the centerpiece of both the FDIC's and the FSLIC's reform proposals. While the IBAA supports the concept of risk-based premiums and would support efforts by the regulators to develop measures of risk which are equitable, I do not think that such a change is going to instill a significant degree of market discipline or is going to be a panacea to restore the soundness and integrity of the insurance funds. Congress' first priority should be to perfect the funds against the virtually unlimited liability posed by large bank failures and to restore a sense of fairness to the treatment of all depositors.

Fourth - In making these various reforms, Congress should address the politics and management of the Federal bank regulatory agencies. For example, the FDIC Board should be enlarged and depoliticized, so that it better represents the interests of the banks that are currently being treated as "too small to save." We recommend that the Board be expanded to at least five members and should consist of individuals who have "hands-on" banking experience. At least one director should have a banking background which enables him or her to understand and empathize with the nation's small community banks. This would provide a wider range of banking experience within the Board's membership.

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The terms of directors should be staggered and of sufficient length to provide continuity and less political involvement. The appointment in recent years of "cheerleaders" for the Administration has proved generally disruptive to our financial system. Banking laws should be changed by Congress, not by appointed bank regulators. Along these same lines, we also feel strongly that the Office of the Comptroller of the Currency should be removed from the Treasury Department and should be made accountable to a board of directors, in the same manner as the other banking agencies.

My personal contention is that a major contributing cause of the current problems in the insured finanical system is the failure of the regulators to adequately police problem institutions and to anticipate future problems and risks. On the other hand, the four steps outlined here would enhance consumer confidence by strengthening the fund financially, promoting greater market discipline for all banks, and bringing more even-handed management to the fund.

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The second area I would like to discuss this morning is the FDIC's recent efforts to limit its potential insurance

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losses through regulation. In general, the IBAA supports and recognizes the FDIC's need to protect itself against undue risks but prefers to see this done in a way that does not unfairly discriminate against smaller institutions and does not unduly limit the legitimate investment activities of well-managed, healthy banks.

The FDIC's main regulating effort to reduce losses and instill greater market discipline has involved brokered deposits. The FDIC last year issued a regulation limiting deposit insurance for all deposits placed by or through brokers to $100,000 per broker, per insured institution. This regulation currently is being challenged in the courts.

In general, the IBAA has supported Chairman Isaac in his effort to limit the indiscriminate access by banks to "hot money" by denying deposit insurance for such funds. We do not believe that these deposits--which are essentially large CDs broken up into $100,000 chunks--are entitled to the protections designed for small depositors. In addition, we have supported the FDIC's monthly reporting requirements, by which banks with brokered deposits in excess of the bank's total capital or five percent of the bank's total deposits must file monthly reports with the FDIC.

Unfortunately, several of the agencies' other proposals to instill market discipline through regulation would be far

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less effective and would have a harmful effect on well-run institutions. First, the FDIC has proposed that all banks be required to maintain total capital of nine percent, with up to three percent allowed in the form of subordinated debt. This compares to the existing 5 1/2 percent primary and 6 percent total capital requirements.

While we support the idea that all insured banks should maintain healthy levels of capital, the issue of subordinated debt poses serious problems for many of this country's smaller commercial and agricultural banks. Subordinated debt is simply not a viable vehicle for community banks, because little, if any, market exists for such debt issuances and the costs associated with public issuance of these debt instruments are too high. Therefore, small banks would be compelled to seek <u>equity</u> capital to meet the 9% level, a far more difficult proposition for most institutions. Because the money center banks have a significantly greater ability to raise subordinated debt than do smaller institutions, this regulation would place community banks at a serious competitive disadvantage.

In addition, a flat 9% rule is too simplistic. Acting Comptroller of the Currency Joe Selby noted recently--quite correctly--that an across-the-board net capital requirement may not make good economic sense. He indicated that his office is considering a more sophisticated "risk asset

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approach" which would take a number of risk factors into account, including off-balance sheet activity. The IBAA strongly recommends that the regulators thoroughly consider such a broader-based approach before moving ahead with these capital requirements.

Likewise, we are tremendously disturbed by the FDIC's proposal to require increased disclosure of financial information and enforcement actions taken against banks by the FDIC. While such a measure theoretically sounds as though it would instill greater market discipline, these proposed rules would harm both poorly managed and well managed institutions.

First of all, it is well known that smaller institutions are more often the target of formal regulatory action, simply due to their size and lesser capacity to defend themselves legally against the government. Such a regulation would result in the false public perception that smaller institutions are somehow less safe than larger ones. Second, the financial information currently available to the public is sufficient for most investors to evaluate a bank's condition and to place their money accordingly. Third, more disclosure across-the-board will likely encourage runs on smaller institutions which are without the resources to withstand them. Fourth, such action by the FDIC discriminates against state nonmember banks since the OCC and

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the Federal Reserve are not requiring the same degree of disclosure by banks under their supervision.

The bottom line is that it is very difficult and often counterproductive for the FDIC to attempt to limit its insurance liability through blanket regulations which impose restrictions on, or compel disclosure by, all institutions. Many of the problems which the FDIC is attempting to solve can be better addressed through improved bank examination, better supervision of problem banks, and stronger enforcement action, rather than through burdensome across-the-board regulation.

In conclusion, we thank you for providing the Independent Bankers Association of America a chance to participate in these hearings. We look forward to working with the Committee in fashioning deposit insurance reform which treats all institutions and depositors fairly, encourages the greatest possible degree of market discipline, and avoids excessive government regulation.

Thank you.

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APPENDIX A

BANK FAILURES WITH "MODIFIED PAYOUTS" TRANSFER OF INSURED DEPOSITS 1983-1985

	Name and Location of Failed Bank	Date of Failure	Deposit Size	Uninsured Deposits Not Transferred to Acquiring Bank	% Advanced by FDIC on Uninsured Deposits	Net Potential Loss to Depositors
1.	Union National Bank of Chicago, Chicago, IL	July 8, 1983	$23.5M	$1,500,000	0	$ 1,500,000
2.	Atkinson Trust & Savings Bank, Atkinson, IL	November 22, 1983	$18.6M	$ 65,000	0	$ 65,000
3.	Indian Springs State Bank, Indian Springs, KS	January 27, 1984	$25.7 M	$800,000	0	$ 800,000
4.	Seminole State National Bank, Seminole, TX	March 16, 1984	$41.3 M	$705,000	55%	$ 387,750
5.	Security National Bank of of Lubbock, Lubbock, TX	April 13, 1984	$40.6 M	$1,100,000	40%	$ 440,000
6.	Gamaliel Bank, Gamaliel, KY	April 18, 1984	$21.6 M	$338,000	55%	$ 338,000
7.	United American Bank, Chicago, IL	April 26, 1984	$29 M	$2,000,000	60%	$ 1,200,000
8.	First National Bank, Snyder, TX	May 4, 1984	$15.2 M	$347,000	40%	$ 138,800
9.	National Bank of Carmel, Carmel-by-the-Sea, CA	May 8, 1984	$70.8 M	$4,600,000	60%	$ 2,760,000
10.	First Continental Bank & Trust Co. of Del City, Del City, OK	May 11, 1984	$92.3 M	$2,300,000	40%	$ 920,000
11.	Republic Bank of Kansas City, Kansas City, MO	June 18, 1984	$37 M	$747,000	0	$ 747,000
12.	American Bank, St. Joseph, TN	June 27, 1984	$30 M	$727,000	0	$ 727,000
13.	Dayton Bank & Trust Co., Dayton, TN	November 30, 1984	$45.2 M	$482,000	75%	$ 361,500
14.	Uehling State Bank, Uehling, NE	December 18, 1984	$3.3 M	$ 437,000	0	$ 437,000

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BANK FAILURES WITH "MODIFIED PAYOUTS" TRANSFER OF INSURED DEPOSITS 1983-1985

Name and Location of Failed Bank	Date of Failure	Deposit Size	Uninsured Deposits Not Transferred to Acquiring Bank	% Advanced by FDIC on Uninsured Deposits	Net Potential Loss to Depositors
15. Peoples Bank & Trust Co., Wartburg, TN	February 8, 1985	$19.8 M	$234,000	0	$ 234,000
16. Citizens State Bank, Fulda, MN	February 15, 1985	$34.7 M	$331,000	0	$ 331,000
17. First Trust Bank of Lakefield, Lakefield, MN	May 31, 1985	$20.4 M	$197,000	0	$ 197,000
18. Strongs Bank, Dodgeville, WI	June 14, 1985	$30.8 M	$2,688,000	0	$ 2,688,000
19. Golden Pacific National Bank, New York, NY	June 21, 1985	$157.1 M	$9,000,000	0	$ 9,000,000
20. Park West Bank, N.A. Farmers Branch, TX	August 15, 1985	$16.9 M	$5,500,000	50%	$ 2,750,000

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APPENDIX B

Independent BANKERS ASSOCIATION OF AMERICA
WASHINGTON OFFICE
1625 MASSACHUSETTS AVENUE N.W. · SUITE 202, WASHINGTON, D.C. 20036 202/332-8980

November 30, 1984

Honorable Donald T. Regan
Cabinet Council on Economic Affairs
Department of the Treasury
15th & Pennsylvania Ave., NW
Washington, D.C. 20220

Dear Mr. Secretary:

The Cabinet Council's review of our system of deposit insurance is most timely. The issue of the safety and soundness of the banking system and in turn, its deposits, is very much on the minds of the American consumer and American business. The near failure of Continental Illinois and the unprecedented announcement of the FDIC on May 17 that "all depositors and general creditors of the bank will be fully protected" underlined the problems and inequities of the present system.

We agree wholeheartedly with your comments before the U.S. League that insured institutions should not make bad loans on the assumption that the government will bail them out. It is not community banks that have been the beneficiary of government assistance. If an actuarially sound system financed by depositors is vastly preferable to a system carried by taxpayers' subsidies, as you stated, then large banks must be made to pay into the insurance system an amount which fairly represents the risk they place on the entire system and the disproportionate claims they are likely to make on the insurance fund in the event that they require assistance.

Knowing that the Cabinet Council on deposit insurance reform is developing its recommendations, the IBAA's special committee on deposit insurance reform met recently to develop our recommendations for the Council's consideration. We have briefed Assistant Secretary Thomas Healey on our deliberations and appreciate this courtesy. Attached is the list of resolutions adopted by our committee which set forth our policy recommendations. Our committee is still reviewing the issue of the appropriate level of capital for banks, including what percentage of capital could be subordinated debt. We do feel very strongly that thrifts, which have almost all the powers of commercial banks, must have their capital requirements phased up to commercial bank levels.

Also enclosed for your consideration is our recent comment letter to the FDIC regarding increased disclosure of financial information.

The IBAA stands ready to assist the Cabinet Council in any way as it seeks to design an insurance system that is both equitable and actuarially sound and which meets the public purposes for which it was originally designed.

Sincerely,

A. J. King
President

Enclosure

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RESOLUTIONS OF THE IBAA FEDERAL LEGISLATION COMMITTEE'S SUBCOMMITTEE ON DEPOSIT INSURANCE REFORM, NOV. 15, 1984:

The IBAA fiscally and philosophically opposes 100% insurance coverage of deposits. But recognizing the current reality, as long as 100% coverage exists for large banks it should be extended immediately to all banks.

A more rational and equitable deposit insurance system should comprise the following elements:

1) We strongly support maintaining the current $100,000 level of deposit coverage. This level of coverage is essential to maintain confidence in the banking system.

2) The IBAA supports tying rebates of the insurance assessments to a bank's riskiness, as proposed by the FDIC in its report to Congress. Riskiness would be correlated with a bank's CAMEL rating, especially its exposure to interest rate and credit risk. But those elements of the CAMEL rating which are subjective, particularly loan classifications and management, should be weighted less heavily than more objective factors. Domestic and foreign loans must be accorded the same treatment. And a method for appealing a bank's CAMEL rating must be established.

We recommend a greater differential between banks in different risk categories than the FDIC has proposed. The IBAA would support an increase in the assessment rate if that is necessary in accordance with actuarial soundness. If assessments of the current rate of 1/12 of a percent are insufficient to allow rebates, we would support variable rate premiums based on risk on the front end.

In addition to assessing a bank's individual risk, banks should be assessed a separate charge according to the systemic risk they pose for the deposit insurance fund and the U.S. Treasury. This risk should be measured by the draw a bank might make upon insurance fund resources in the event of a failure or rescue.

3) The IBAA supports assessments on foreign deposits at a level equal to that on domestic deposits.

4) The IBAA supports the removal of insurance on the deposits of federal government agencies and on all brokered state and local deposits. We do not support removal of insurance on state and local government deposits or deposits placed directly by financial institutions as contrasted with the removal of such insurance from brokered deposits.

5) If the FDIC is forced to pay off in the event of failure, the modified payoff approach is the best system for doing so.

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6) The FDIC should act as insurer only. The Federal Reserve should serve as lender of last resort and source of liquidity for banks.

7) The IBAA feels that the FDIC should have the authority to examine any institution that it insures.

8) Thrifts which now are empowered to take demand deposits and make commercial loans should have the same capital requirements as commercial banks and this parity in capital should be phased in over a six year period. Thrifts should not be allowed to expand their activities until such time as they reach capital levels equal to commercial banks.

Use of the name "Bank" should be disallowed for any financial institution that does not meet the minimum capital requirements of FDIC insured commercial banks or any other requirements made by a bank regulatory authority.

9) The Board of Directors of the FDIC should be expanded to insure broad industry representation.

The CHAIRMAN. Thank you, Mr. Backlund.
Mr. Cairns.

STATEMENT OF JAMES G. CAIRNS, JR., PRESIDENT, AMERCIAN BANKERS ASSOCIATION; PRESIDENT, PEOPLES NATIONAL BANK OF WASHINGTON, SEATTLE, WA, ACCOMPANIED BY A. GILBERT HEEBNER, CHAIRMAN, ABA OVERSIGHT COMMITTEE ON DEPOSIT INSURANCE REFORM AND SAFETY AND SOUNDNESS

Mr. CAIRNS. Thank you, Mr. Chairman. We appreciate the opportunity to be here with you today and with your colleagues. I am accompanied by A. Gilbert Heebner, who is executive vice president and economist for the CoreState Financial Corp. in Philadelphia. Mr. Heebner is the chairman of the ABA's oversight committee on deposit insurance reform.

For many reasons, including the plight of the thrift industry and its effect on the FSLIC, many have become concerned about the insurance funds and we appreciate you, Senator Garn, and the committee affording us the opportunity to address this very important subject for the record.

To begin, we believe the system's basic structure, that of an industry-funded pool of resources administered by a Federal agency, remains a sound and a desirable means of assuring public confidence and enhancing financial stability.

We are concerned, however, that in the public's eye there is no difference between the FDIC and the FSLIC. We here all know that there are substantial differences, differences that are important in any discussion of the future of the system.

ABA ANTICIPATED THE NEED FOR INSURANCE REFORM

For some time, the ABA has anticipated that practices followed by the thrift industry would lead to a discussion of the insurance funds. We established an oversight committee chaired by Mr. Heebner on deposit insurance reform early last year and his committee has reviewed and commented upon studies prepared by five expert consultants that we retained. He has forwarded those reactions and recommendations to our Government Relations Council.

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Like your committee, the ABA is in the midst of its review of this important subject. A presentation on deposit insurance reform will be made to our banking leadership conference here in Washington, DC, tomorrow, and our policy group, the ABA board of directors, will meet on this subject also this week. It would be at that time that we would be able to give you more detailed recommendations than we can today.

I believe it's important to note that the ABA has also just established a commission on safety and soundness which is composed of bank executives of all sizes and geographic regions which held its first meeting in early August. Its primary focus will be to develop proposals for industry self-regulation and proposals to enable banks to better manage risks which we hope will enhance the public's confidence in the banking system.

I mention this here because as a foundation to our thinking we believe that the basic FDIC structure is sound. We are concerned, however, that practices followed by the thrift industry have caused severe problems for the FSLIC and we want to avoid a similar occurrence at the FDIC.

On the subject for today, we suggest the first question that should be asked is: What does it take to maintain a strong insurance fund?

First, it takes a strong banking system. That is, it requires that commercial banks have the opportunity to efficiently serve their customers with financial products and services that can maximize customers' convenience and, very importantly, contribute to bank profitability. Needs for earnings must be balanced with reasonable risks which can be achieved through proper diversification of our banking activity and efficient use of our resources.

Second, the bank must be run honestly with capital sufficient to support the activity of the bank. Wherever there is dishonesty or impaired capital without a realistic probability for restoration, the institution in our opinion should be closed promptly.

In our opinion, while these two objectives are laudible, they are not obtainable so long as product and service legislation is not enacted. We believe that without such legislation it is possible individual banks may take on excessive levels of risk as they struggle to stay profitable within their constrictive product lines, creating an unhealthy risk to the FDIC fund.

The single most important thing to assure the FDIC's continued ability to achieve its objectives is for the Congress to enact legislation allowing banks to maintain their profitability and to better serve the public.

For today's discussion, we believe the committee should focus on several issues. The first issue is that of fairness in the treatment of all types of financial institutions regardless of size or charter when there is a failure.

MODIFIED PAYOFF APPROACH

Our oversight committee, while aware of the questions of fairness raised by such episodes as the handling of Continental Illinois, is opposed to 100-percent deposit insurance coverage as a solution. Such coverage would greatly expand the exposure of the deposit in-

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surance funds while forfeiting the market discipline that could be imposed by sophisticated investors who own large deposits. Therefore, the committee has urged that consideration be given to a modified payoff approach to assure that all depositors receive equal treatment and protection.

Under this approach, those with insured deposits in a failed bank would continue to have immediate access to their funds. Uninsured depositors and creditors would receive a pro rata share based upon insurance agency estimates of recovery during liquidation. If subsequent recoveries exceed their estimate, these parties would receive additional proportional reimbursement.

Our committee also favored the concept of establishing an FDIC-administered trusteeship to operate an institution pending its ultimate disposition in the event that it is not practical to close the institution immediately. Depositors would be treated in exactly the same manner as under the modified payout approach without a trusteeship.

Legislation requiring that modified payoffs, with or without trusteeship, would be utilized in all financial institution failures would clearly put uninsured depositors and creditors on notice that their deposits were at risk.

CAPITAL STANDARDS

The second issue is that of capital standards. Our committee does not believe that it has been demonstrated that present capital levels are inadequate. As a matter of fact, the capital in commercial banks has increased both in dollars and as percentage of assets significantly over recent years. Further, capital in commercial banks is significantly higher than that in the thrift industry.

There are those who suggest that bank capital be augmented by subordinated debt. We all know that subordinated debt is not the same as equity and we are very concerned that all commercial banks do not have the same ability to raise subordinated debt because they lack the same access to the capital markets.

The third issue is that of the proper level of disclosure. A great deal of information about banks is already available and it may not be adequately utilized simply because current practices foster the impression that risk to uninsured depositors and creditors is quite low. The requirement for a modified payoff would change that perception and make existing information more valuable.

The fourth issue is that of risk-related deposit insurance premiums or capital. The current flat-rate system does present some problems. While we are concerned about these problems, we are also concerned about the difficulties of implementing a risk-related system. More frequent examinations of problem banks with the banks being assessed according to the time spent in these reviews might prove a better means for discouraging risky strategies and more fairly allocating the cost of the deposit insurance system.

These same concerns would extend to proposals for risk-related capital. Please remember that the regulators today have complete legal freedom to require banks to maintain capital levels higher than the uniform minimum standards.

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The fifth issue is the proper scope of examinations. The detection of fraud should play a much larger role in the supervision and examination process. Also, the agencies should expand their use of statistical and computer-based modeling in monitoring and identifying risks with particular attention to methods already developed by the private sector.

Finally, there is the issue of merging the FDIC and the FSLIC. Our committee is strongly opposed to such a merger. We do recognize current strains on the FSLIC, but we believe that merging the FDIC and the FSLIC funds by itself would do nothing to redress the real problems of the thrift industry, particularly when there exist continuing large disparities between capital requirements, accounting procedures, and regulatory treatment of banks versus thrifts.

In summary, we believe there is no substitute for good management of financial institutions, of the regulatory agencies who supervise them, and of the funds which insure America's depositors. If management does not perform it needs to be replaced. However, we caution that we don't want to throw out the baby with the bath water. The basic system we have is 50-plus years old and has served us well, but there are several questions that should be asked.

Why haven't failed institutions been closed? Why does it take so long to recognize and rid ourselves of those who have committed a fraud? Why haven't we shored up the ability of commercial banking institutions to sustain a steady stream of income from a diversified base of business?

It's curious to note that despite all the public policy commitments about maintaining the separation of banking and commerce, we read news stories that General Motors Acceptance Corp. has become the second largest mortgage banking firm in the United States; that the Chrysler Financial Corp. recently acquired the E.F. Hutton Credit Corp.; that Metropolitan Life is acquiring Century 21; and that Ford Motor has agreed to acquire First Nationwide Financial Corp., a nearly $11 billion thrift, the eighth largest in the country.

The final question that might be asked is, where do we go from here?

We are pleased that this process has begun and we are anxious to be a part of that. Thank you.

[The complete prepared statement follows:]

Testimony of

JAMES G. CAIRNS, JR.

President of the American Bankers Association

Mr. Chairman and Members of the Committee, I am pleased to be able to testify today on the complex but crucial issues of reform of the federal deposit insurance system, and enhancing the safety and soundness of depository institutions through improved examination and supervision as well as greater industry self-regulation. My name is James G. Cairns, Jr., and I am President of the American Bankers Association and President of the Peoples National Bank in Seattle, Washington. I am accompanied by A. Gilbert Heebner, Executive Vice President and Economist for the CoreStates Financial Corporation in Philadelphia,Pennsylvania; Mr. Heebner is Chairman of the ABA's Oversight Committee on Deposit Insurance Reform and Safety and Soundness.

I am here today representing the American Bankers Association whose members hold over 95% of the commercial banking assets in this country.

The ABA commends Chairman Garn and the Committee for commencing this timely reconsideration of the assumptions underlying the deposit insurance system and re-examination of mechanisms which have been in place for more than half a century. The ABA believes that the system's basic structure — that of an industry-funded pool of resources administered by a federal agency — remains a sound and desirable means of assuring public confidence and enhancing financial stability. And we believe that the FDIC fund remains more than adequate to deal with any foreseeable contingency.

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Nonetheless, we are aware of Congressional and public concern regarding a series of recent and well publicized financial institution failures. Media images of the anxious depositors of privately insured Ohio and Maryland thrifts have inevitably had some detrimental effect on public confidence in all financial institutions. We are also aware of the continuing severe problems being experienced by many thrift institutions, and the strain which these problems are placing on the FSLIC.

Bankers are also concerned about the efficacy of regulatory supervision, as well as some fairness issues which have been raised by recent occurrences. The failure of the Penn Square Bank demonstrated how brokered deposits could underwrite unwise management strategies, and encouraged the FDIC to experiment with modified payouts. The rescue of Continental Illinois has raised the question of whether some large banks cannot presently be closed by the FDIC, thereby providing large depositors with de facto 100 percent insurance coverage. The structure of Continental's rescue has also suggested the need to enhance the separation between a bank and its holding company's subsidiaries and affiliates so that deposit insurance fund monies do not provide assurances to holding company debtholders. Finally, the continuing capital inadequacy of the thrift industry is a great cause of concern for bankers, both in terms of potential impacts on public confidence as well as the fairness of competition between banks and thrifts.

Because the ABA believes that reform of the bank funded deposit

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insurance system is an area in which banks should take the lead in order to accomplish any necessary reforms, the ABA established an Oversight Committee on Deposit Insurance Reform and Safety and Soundness in the summer of 1984. This Committee consists of seventeen bankers with expertise in law, economics, and corporate management coming from banks ranging in size from $34 million to over $100 billion in assets. The Oversight Committee in turn selected a team of five highly respected academic consultants who prepared a series of long and detailed studies of the key problems and issues of deposit insurance reform and enhanced safety and soundness. The Oversight Committee met twice over this past summer to review and comment upon the studies prepared by our consultants' group, and to outline its reactions and recommendations to the ABA Government Relations Council. The Government Relations Council first began to familiarize itself with the complexities of the deposit insurance reform issue at a meeting held in July of this year.

Like your Banking Committee, the ABA is in the midst of its review of this subject and approaches it with no preconceived notions. A presentation on deposit insurance reform will be made to the Banking Leadership Conference, which meets tomorrow. We should be able to advise you later this week of our preliminary policy determinations regarding deposit insurance reform. While the ABA has not yet taken a firm and formal position on many of the issues raised by deposit insurance reform, I am able to share with you the views of our Oversight Committee, which will be the basis of our review tomorrow.

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The ABA has also just established a Commission on Safety and Soundness, composed of bank executives from institutions of all sizes and geographic regions, which held its first meeting on August 8. Its primary focus will be to develop proposals for industry self-regulation which can enable banks to better manage risk, and which can enhance public confidence in the banking system. The Commission, which is scheduled to deliver its final recommendations in February, has already determined that in a competitive environment of greater freedom, maximum reliance should be placed upon market discipline and self-regulation as preferable to increased government regulation.

In summary, the ABA is well aware of the need for the banking industry to be in the forefront of developing and recommending policy initiatives which address the issues of deposit insurance reform and enhanced safety and soundness. We look forward to working with Congress in improving the regulatory and competitive framework in which banks operate.

Our Oversight Committee is aware of the questions of fairness raised by such episodes as the handling of Continental Illinois, but it is strongly opposed to de jure one hundred percent deposit insurance coverage as a solution. Such a decision would greatly expand the exposure of the deposit insurance funds while forfeiting the market discipline that could be imposed by the sophisticated investors who place such deposits. Therefore, consideration should be given to a modified payoff approach to assure that depositors in banks of any size receive equal treatment and protection. Under this

approach, those with insured deposits in a failed bank would continue to have immediate access to their funds. Uninsured depositors and creditors would receive a pro rata share based upon FDIC estimates of recovery during liquidation. If subsequent recoveries exceeded that estimate, these parties would receive additional proportionate reimbursement.

The Committee also recognized that utilization of a purchase and assumption or liquidation might not be practicable in the case of some very large banks, due to both the difficulty of rapidly assessing the worth of their portfolios as well as potential market disruptions. Therefore, it favored the concept of establishing an FDIC-administered trusteeship to operate the institution pending its ultimate disposition. Depositors would be treated in exactly the same manner as under a modified payoff without a trusteeship, receiving pro rata recovery of uninsured amounts at the time the trusteeship was established. Let me emphasize that this trusteeship would not result in discriminatory treatment of large and small banks — it is an administrative tool to assure that all bank failures result in equal treatment of uninsured deposits.

Legislation establishing that modified payoffs, with or without trusteeships, would be utilized in all bank failures would clearly put uninsured depositors and creditors on notice that their funds are at risk, and provide the necessary encouragement to assure exercise of market discipline. The trusteeship option would eliminate any doubts about the willingness of the regulators to impose losses on those with

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funds in even the largest banks.

Finally, the Committee recognized that there could be transitional problems in moving to these new and uniform methods of handling bank failures. To minimize these problems, the law should guarantee that a minimum percentage of uninsured deposits be recovered, and this guaranteed percentage should be phased down and out over time.

In regard to proposals for higher bank capital requirements, our Committee does not believe it has been demonstrated that present capital levels are inadequate. Further, while utilizing subordinated debt as a portion of this capital level might add some additional market discipline, we are concerned about the ability of smaller banks to market such instruments. The banking regulators, responding to Congress recently instituted uniform higher capital requirements for all size banks. Utilizing subordinated debt could undermine that uniform treatement. And, while it has been suggested that small banks could sell subordinated debt to correspondents, we question whether that market would exist and fail to see how it would reduce overall risk within the banking system. However, we do believe that banks should have the abilities to use subordinated debt as an option in satisfying a protion of their current capital requirements.

While any movement toward market discipline does require adequate disclosure, a great deal of information is already available, and may not be adequately utilized simply because current practices foster an

impression that risk to uninsured depositors and creditors is quite low. The key task for policymakers would seem to be providing an assurance of real risk to those market participants capable of utilizing and acting upon this information. If such a risk is assured by the policymakers, the proper disclosure will be forthcoming on a voluntary basis for those who wish to obtain funds exceeding deposit insurance limits.

Our Committee also reviewed proposals for risk-related pricing or rebating of deposit insurance premiums. The current flat rate system does present problems in that banks with the lowest and highest risks pay the same rates, and there is no incentive to refrain from inappropriate risk-taking. While the Committee was concerned about these problems, it was even more concerned about the difficulties of implementing a risk-related system. Were such a system to be established, banker input into its administration and risk-rating criteria would be essential to prevent it from becoming a bureaucratically burdensome form of credit allocation and management second-guessing. Even if those problems could be avoided, it is not clear that the monetary differentials obtainable under such a system could provide effective disincentives. More frequent examinations of problem banks, with the banks being assessed according to time spent for these reviews, might provide a better means for discouraging risky strategies and more fairly allocating the costs of the deposit insurance system.

These same concerns would extend to proposals for risk-related

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capital. In addition, we would note that we have an ad hoc system to this effect at present, with the regulators having complete legal freedom to require banks to maintain capital levels higher than the uniform minimum standards. And, as noted, we are not convinced that the banking system as a whole is not adequately capitalized. However, implementing a modified payoff system could be expected to result in the market acting to force banks perceived as riskier to maintain higher capital if they wished to attract uninsured deposits.

With respect to examination and supervision, the detection of fraud should play a much larger role in the supervision and examination process. Also, the agencies should expand their use of statistical and computer-based modeling in monitoring and identifying risk, with particular attention to methods already developed by the private sector.

Finally, the ABA would strongly oppose the elimination of the separate deposit insurance funds through the folding of deposit insurance premiums into general Treasury revenues. And, while we recognize current strains on the FSLIC, we believe that merging the FDIC and FSLIC by itself funds would do nothing to redress the real problems of the thrift industry.

Having provided this background on ABA's consideration of deposit insurance reform to date, and reemphasizing that we are currently in the process of developing firm positions on many of the key questions raised by this subject, I will nevertheless attempt to respond to the

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specific questions contained in your letter of invitation.

1. Improving the assessment of financial institution condition.

While we believe that the present system of supervision and examination is generally adequate, some improvements may be desirable in adjusting to an environment of greater competition in the financial services arena. In particular, we feel that the banking regulatory agencies should have adequate resources to attract and retain top quality personnel. Also, while the regulatory authorities have access to large amounts of information available about particular financial institutions, there is some question as to whether they utilize this information effectively, particularly in regard to failure prediction. There appear to be a number of private sector analytical models which may be more accurate in predicting bank failures than the FDIC's CAMEL rating system. We suggest that your Committee explore, in consultation with the FDIC, the desirability of adopting such options for making better use of existing data.

2. Differentiating between financial institutions.

A great deal of information already exists for those interested in grading the quality of a particular bank, and the primary means of assuring that it is utilized to exert desirable discipline is to increase the market's perception of the risk of unwise funding decisions. The private sector already appears to be acting in this regard as evidenced in an August 6, 1985 Wall Street Journal article

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(attached) describing the increasing influence of the Keefe Bruyette Bank Watch Service on the placement decisions of institutional depositors. The article also notes that Standard & Poor's has instituted a similar rating service and that other credit rating agencies are preparing to enter this field. In the future, it is less likely that any uninsured institutional depositor would choose an extra few basis points when it requires funding an institution which receives low ratings from multiple credit analysts.

The question of more explicit policy guidelines for different types of enforcement actions is a difficult and highly technical one. While we are as yet unprepared to make recommendations, the primary consideration should be to accord fair and reasonably uniform treatment to problem banks while maintaining necessary flexibility for the regulatory authorities charged with responding to their difficulties.

In this context, Mr. Chairman, I do want to take this opportunity to bring to your Committee's attention the very serious concerns of many agricultural bankers regarding their perception of overzealous loan classification practices by bank examiners. While the personnel of the regulatory agencies cannot ignore nonperforming farm loans, they must also recognize that most of these credit decisions were sound at their time of origination, and have been undermined by unforeseen and unpredictable economic shifts. Forcing banks to foreclose on some of these loans is an action with negative ramifications for the farmer, the banker, and their entire community.

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We hope that your Committee will use its oversight authority to assure that bank examinations are realistic, but not adversarial — and that examiners err on the side of reasonable forebearance in those situations where problem loans may be worked out over time.

As noted, while we are sympathetic to relating deposit insurance premiums to risk, we are quite concerned about the implementation of such policies. Any such risk-related system should be objectively calculated and should accord the maximum possible role to industry self-regulatory standards, as opposed to mechanistic regulatory formulas. We cannot endorse a risk-related system which gives federal regulators the power to veto management initiatives or allocate the distribution of credit. Banks can never be free from risk — in fact the service they provide to society is the analysis, evaluation and assumption of financial risk. Risk comes in many different guises, and different types of risk which would be excessive in and of themselves can ameliorate one another within a well-reasoned management strategy. In this regard, it is instructive to remember that one of the least risky assets from a default prospective, home mortgages, resulted in excessive interest-rate risk for the thrift industry because of its overconcentration on this one area of lending. If it is to have any relevance or chance of success, a risk-related system must focus on whether risk is being successfully managed, not on whether it is being avoided.

Also, as banks gain entry to new fields of financial competition, we would be unlikely to support any system which increased capital or

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insurance premium requirements solely on that basis. Such an "entry tax" approach would be blatantly unfair to banks vis-a-vis other financial sector competitors and would fail to recognize that a banking organization's overall risk will be reduced by its diversification into new lines of financial products and services.

3. Handling liquidity and solvency crises.

As previously noted, policy guidelines for handling bank crises must balance the need for fair and equitable treatment of banks against the need for regulatory flexibility to fashion responses appropriate to individual circumstances. Whatever the outcome of your deliberations on this matter, we believe that even if some major institutions cannot be immediately liquidated and paid off because of the potential disruption to the financial system and the economy, methods must nonetheless be developed which assure a fairness of treatment of their depositors vis-a-vis those of smaller banks. Utilization of modified payoffs and trusteeships for failed banks can achieve this.

That is, large institutional depositors must know that public policy dictates that unwise funds placement decisions in any bank can have stinging consequences. While the deposit insurance agencies must protect their fund assets, other policy considerations — such as the rights of management and shareholders, and the importance of an institution to a community — must also be factored into the ultimate decision. In particular, the ABA is very concerned about proposals to

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provide the insurance agencies with authority to require mergers prior to institutional insolvency. At the same time, we believe the agencies should have a broad array of other enforcement and disciplinary tools; and should enhance their monitoring capabilities so as to be better able to close banks at the moment of insolvency -- to the extent this can be achieved, the cost of failures to the insurance funds would be greatly lessened. Last, but by no means least, insolvent institutions should not be permitted to operate -- we never want to see the FDIC exposed to the dangers that the FSLIC is now facing because it let bankrupt thrifts continue to accept the public's deposits.

Also, many in the banking community remain opposed to proposals for merging the FDIC and FSLIC funds, at a time when there exists continuing large disparities between the capital requirements, accounting procedures, and regulatory treatment of banks versus thrifts. For example, while insolvent banks are closed immediately, an FHLBB study shows that one out of seven FSLIC-insured institutions now operating are technically insolvent. And an ABA economic comparison of banks and thrifts shows that, as of December 1984, commercial bank primary and secondary capital stood at 6.76% of assets, compared to 0.91% for FSLIC-insured thrifts. Bankers welcome competition -- but is it fair competition when the thrift across the street is insolvent and has greater powers to boot? And should bankers subsidize this inequality through a merger of the insurance funds?

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Finally, we believe the current Federal Reserve policy regarding access to the discount window deserves Congressional review. Some believe that their insistence on full collateralization may exacerbate liquidity difficulties and restrict ultimate options for dealing with a troubled institution.

Also, the discount window should never be used to keep an insolvent institution afloat, and should primarily address the ripple effects of a bank's failure on the financial system.

4. Private Deposit Insurance

The runs on privately insured thrift institutions in Ohio and Maryland have demonstrated the weakness of privately funded and administered deposit insurance funds in a time of crisis. Nonetheless, private insurance systems may have some useful role to play in providing supplementary coverage above the statutory deposit insurance limits, both as a means of enhancing the stability of the financial system and for imposing yet another lever for market discipline. This appears to be one area where the market will act on its own, without any need for legislative sanctioning.

CONCLUSION

Because of the great importance of the deposit insurance system and the need to fine tune it in view of new marketplace realities, the ABA initiated steps last year so that the banking industry can take the lead in proposing desirable and workable solutions. We hope that

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any legislation resulting from these hearings will provide sufficient assurances of banking system discipline to better pave the way for continued financial deregulation — and will not impose new regulatory constraints on banking institutions which leave them less viable in the competitive environment we face for the rest of this century.

Deposit insurance reform can do much to encourage a healthy banking system, but it cannot guarantee a healthy banking system. The only assurance of bank health is bank profitability, and profitability depends upon remaining fully competitive. To make an analogy, we would think a health insurance system was unfair and unsound if it failed to differentiate between a person in perfect health and an individual of the same age who was 100 pounds overweight, smoked five packs of cigarettes a day, had hyper-tension, and didn't follow medical advice. We would certainly prefer a system which rewarded individuals who stayed healthy and provided incentives for the unhealthy to reform their ways. On the other hand, we would not think it realistic to expect the health insurance system to save the terminally ill, or to prevent malnutrition and its resulting infirmities. Similarly, we would hope that deposit insurance reform would lead to a system which better rewards prudent and effective management, and which provides disincentives for excessively risky strategies. However, we cannot expect deposit insurance reform to save those institutions which have gone past the point of no return. Nor can we expect it to assure the profitability of the banking system in a rapidly changing, competitive environment.

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In short, we must have reasonable expectations of what insurance reform can and cannot accomplish. It can provide for greater fairness, worthwhile incentives, more accurate appraisals, and more timely intervention. But it cannot enhance the bottom line profitability which is the ultimate insurer of bank health. Nor can it or should it prevent all bank failures. Interest rate deregulation inevitably increased the penalties for asset/liability mismanagement, and created a more competitive environment. But these difficulties are more than offset by the public benefits of market rates and the enhanced overall competitiveness of the banking system. We think that the regulatory structure and its resources can largely handle the challenges of a market-oriented financial system now, but that deposit insurance reform can further enhance the efficiency and fairness of the financial marketplace.

However, deposit insurance reform will not change the fact that commercial banks must compete against thrift organizations operating with many more opportunities for diversification and the generation of fee income. It is time, in fact past the time, when commercial banks should be permitted to bolster their fee income and serve the public through such low-risk activities as insurance and realty brokerage.

Deposit insurance reform will also do nothing to change the fact that traditional commercial bank assets are increasingly being securitized. The top tier of commercial and industrial firms in the United States, which formerly constituted the top quality loan customers of the commercial banking industry, now raise the vast

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majority of their short term funds in the commercial paper market. In fact, there is now slightly more commercial paper outstanding than there are commercial and industrial loans extended by commercial banks. The next lower rung of corporate America is now exhibiting a similar pattern through the issuance of "junk bonds", which are really higher interest bearing, lower quality commercial paper. Thirty percent of residential mortgages are currently being securitized and this trend is likely to continue. Other types of debt instruments, such as automobile loans and consumer receivables, are beginning to be packaged into securities for resale in the secondary market. And, of course, money market mutual funds remain an attractive functional equivalent to transaction accounts for many individuals and permit securities firms to offer customers the functional equivalent of banking in tandem with securities brokerage and investment advice.

We're not here to argue that Congress should step in and stop the securitization process. The market place is driving this process, because securitization generally offers a lower cost of raising funds than traditional debt finance. Our concern is that banks are not being permitted to follow and serve their traditional customers as the market place evolves. It is particularly ironic that higher capital requirements are increasingly being proposed as a solution to banking's problems, when the efficiency of the securitization process — and its ability to offer lower financing costs to traditional bank borrowers — is based on its more efficient use of less capital to leverage an equivalent amount of credit. We need to ask whether the $52 billion cost (St. Louis Federal Reserve Bank estimate) to banks,

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and ultimately to the economy, of moving to a 9% capital standard is the most rational response to whatever need exists to reduce FDIC outlays and impose desirable discipline.

Further, while recent court decisions have shelved the nonbank loophole as a device for geographic expansion by bank holding companies, the loophole remains open for commercial and industrial firms seeking to acquire state banks to gain access to the payment system and FDIC insurance coverage. The Congress has yet to close the nonbank bank loophole, and even the bill which recently emerged from the House Banking Committee would grandfather the presence in the banking system of such insurance companies as Kemper, Prudential, and Travelers; of such securities firms as Fidelity, Shearson/American Express, Dreyfus, and E.F. Hutton; and of financial conglomerates such as Gulf & Western, Household International, Beneficial, J.C Penney, and Control Data Corporation's Commercial Credit Division.

Finally, despite all the public policy commitments to maintaining the separation of banking and commerce, we take note of recent news stories that General Motors Acceptance Corporation has become the second largest mortgage banking firm in the United States; that the Chrysler Financial Corporation recently acquired the E.F. Hutton Credit Corporation, a specialist in equipment and leasing financing; that Metropolitan Life is acquiring Century 21 in order to combine realty brokerage, mortgage banking and insurance; and that Ford Motor Company has agreed to acquire First Nationwide Financial Corporation, at nearly $11 billion in assets the eighth largest thrift institution

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in the United States. Anthony M. Frank, First Nationwide's Chairman and CEO, displayed little concern about Congress' threatened limitation of tandem operations when he stated upon announcement of the proposed acquisition, "teaming us with Ford Motor Credit, the world's second largest consumer finance company, will enable Ford to serve the broad middle class of our country by offering financing for two of the largest purchases that most families ever make — their home and their auto".

I would submit, Mr. Chairman, that the commercial banking sector cannot remain strong over the long term unless it can build upon its existing mandate in order to freely and fairly compete in the modern financial marketplace. Recently, former Bank Board Chairman Jay Janis told you that many of the thrift industry's current problems could be ascribed to the Congressional decision to deregulate liabilities prior to assets, and its failure to recognize that deregulation would cause some problems. While insurance firms, securities underwriters, and auto companies continue to expand their financial services and presence in the depository system, bankers continue to be denied even the most modest entry into financial products and services areas where risk is quite manageable, and where customer demand is quite evident. If Congress wants to ensure bank safety and soundness, it should let us compete in this real world marketplace.

In conclusion, the ABA stands ready to propose and support reforms of the deposit insurance system which will make it more

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responsive and attuned to the new competitive environment. At the same time, we remain committed to removing legislative and regulatory restrictions which deny banks the opportunity to remain sound over the long term by being fully competitive in the dynamically changing financial environment we face today.

This concludes my statement. I would be pleased to respond to any questions.

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Bank-Rating Service's Influence Grows

Big Depositors Rely, Some Say Blindly, on Keefe Bruyette

By JEFF BAILEY and G. CHRISTIAN HILL
Staff Reporters of THE WALL STREET JOURNAL

With about $8 billion to invest on a short-term basis, Alex Laird, a first vice president of Hutton Asset Management, gets a lot of calls from deposit-hungry banks. But don't bother calling the money manager for the E.F. Hutton Group Inc. unit unless your bank's rating is at least a C on the Keefe, Bruyette & Woods scale of A to E—Mr. Laird won't even consider it.

"We do cursory research," Mr. Laird says. "That's why we rely on Keefe."

It's a similar story at the Federal Home Loan Bank of Chicago. "We rely on the Keefe ratings to determine who we'll sell funds to," says Paul J. Bielat, treasurer, with about $2 billion deposited in banks. Mr. Bielat says the regional home loan banks, in varying degrees, build the Keefe ratings directly into their investment policies.

Ratings Service's Influence

The reliance of these two big money managers on the ratings illustrates the growing influence of Keefe's bank rating service, known as Bank Watch. The New York-based bank securities firm rates the 300 largest U.S. banks, 100 big foreign banks and a growing number of thrifts. The 650 Bank Watch subscribers, like Messrs. Laird and Bielat, include many of the biggest sources of bank deposits. In addition to money market funds and the Federal Home Loan Bank system, cash-rich corporations, municipal treasurers, insurance companies, foreign central banks and bank trust departments buy the Keefe service.

And many of these institutions follow almost blindly the Keefe ratings in choosing where to deposit their money.

For banks, the existence of a single service that can so broadly influence funding customers only adds to the already high level of skittishness in world financial markets. That skittishness was demonstrated by huge depositor runs last year at Continental Illinois Corp. and Financial Corp. of America. Some bankers now worry that Keefe's Bank Watch service, coupled with nervousness, could spark a run on a less-feeble institution.

Keefe Bruyette Rates the Banks

Keefe Bruyette & Woods Inc. Bank Watch ratings for the top 15 U.S. banks

BANK	CURRENT RATING*	CHANGE FROM	WHEN CHANGED
Citibank	A/B	B	Nov. 1984
Bank of America	C/D	C	June 1985
Chase Manhattan	B/C	B	Nov. 1983
Manufacturers Hanover	B/C	B	Nov. 1983
Morgan Guaranty	A	Unch.	
Chemical	B	B/C	Apr. 1985
Security Pacific	B	A/B	Nov. 1983
First Interstate	B	A/B	Nov. 1983
Bankers Trust	B	B/C	Dec. 1982
First Chicago	C	B/C	Oct. 1984
Mellon	B	A/B	Sept. 1984
Continental Illinois	D	E	Sept. 1984
Wells Fargo	B/C	B	Mar. 1981
First Bank Minneapolis	B	A/B	Apr. 1984
Crocker National	C	B/C	Nov. 1983

*As of early July

Source: Keefe Bruyette Watch subscribers, bankers

What the Bank Watch ratings mean:

A-Unquestioned strength, no perceived credit risk at any maturity level.

B-Very strong credit with little or no credit risk at any maturity level. Any unexpected earnings problems would most likely be of a very short-term nature and should not materially affect the credit standing of the company.

C-Average statistical and operating credentials with one or more problems preventing a high-rating, or a situation where weak elements are counterbalanced by other areas of strength. A sound credit with little perceived short-term risk and only modest risk at longer maturities.

D-One or more operating problems of a material nature have already or may in the future hamper the competitive posture of this organization for a period of time. Some credit risk in the short-term area with increasing degrees of risk at longer maturities.

E-Very serious problems will prevent the company from offering any real competition for a period of time. Risk at all maturity levels must be considered real. Continued viability without outside assistance must be seriously questioned.

An Impact Beyond Subscribers

What's more, Keefe's ratings can have an impact even beyond its subscribers. After a rating change, says Bruce Trotter, a Drexel Burnham Lambert Inc. vice president managing $1.5 billion, bank certificate-of-deposit traders often catch wind of it and pass it along to other money managers. "And then there's a ripple effect, with nonsubscribers reassessing the bank, too."

The ratings (see chart) range from A, "Unquestioned strength, no perceived credit risk at any maturity," to E, "Very serious problems. . . . Continued viability without outside assistance must be seriously questioned. . . ." according to subscribers. Subscribers typically get ratings on 75 or more institutions, and Keefe charges $100 annually for each of those ratings. Gregory Root, the Keefe vice president who oversees the 15 Bank Watch analysts, refuses to confirm any ratings or how they're defined—Keefe tries to keep Bank Watch confidential. Mr. Root says the ratings by themselves could be misleading because Keefe also sends clients a two-to-four page commentary on each bank it rates.

But interviews with Keefe subscribers indicate it's the ratings they act on—not the commentary. "We don't put money in a bank with a D in its rating," a money manager who handles more than $7 billion says flatly.

Conflict-of-Interest Question

For Keefe, Bank Watch's ability to affect the fortunes of a particular institution raises a thorny conflict-of-interest question. Keefe also trades bank stocks, which can rise and fall on the news of a Bank Watch rating change. And Keefe, which gives earnings projections and other inside information by banks making a case for a rating.

Harry V. Keefe Jr., chairman of the firm, acknowledges the potential conflict but says his firm has taken steps to make sure it doesn't trade on these advantages. He says Bank Watch analysts don't share their information with traders and others at Keefe. And when Mr. Keefe gets personally involved in a rating, as he did recently with First Chicago Corp. and Bank America Corp., he says the firm won't

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trade the stock of that bank for a period of time and that it freezes any shares it already owns.

The conventional credit rating agencies, which don't trade securities, are hoping to take advantage of concerns over Keefe's potential conflict. Standard & Poor's Corp. recently began marketing a service similar to Bank Watch. Moody's Investors Service Inc. and Fitch Investors Service are eyeing the business. And Duff & Phelps Inc. and McCarthy Crisanti & Maffei also are rating banks' deposits. But for now, says Drexel's Mr. Trottier, "Keefe is the service that has the impact."

That's why Barry F. Sullivan, First Chicago's chairman and chief executive, was in New York one day last June to lobby Mr. Keefe. After a $71.8 million third-quarter loss last year led Keefe to downgrade its rating to C from B/C, the parent company of First National Bank of Chicago had seen a multibillion-dollar chunk of its deposit-gathering strength erode. After a big loss on a Brazilian bank investment again had rocked First Chicago's reputation, Mr. Sullivan was hoping to avoid a further downgrading, to C/D, which would drive away still more big depositors.

The two men discussed the recent problems and First Chicago's future prospects. And Mr. Sullivan, according to Mr. Keefe, went so far as to disclose that First Chicago plans to boost its loan-loss reserve by year's end so that it's equal to 60% of the company's nonperforming loans, up from about 45% at June 30. First Chicago wouldn't comment on any talks with Mr. Keefe.

The C rating was affirmed—but there was a warning. "If he or First Chicago makes another error, they'll go to a C/D," Mr. Keefe says he told Mr. Sullivan. "He's at risk and it's up to him to get his funding lines in order."

Concern Over an Apparent Boost

To another big banking concern with troubles, it looked as if Mr. Sullivan's lobbying gave First Chicago an unfair boost. Samuel Armacost, chairman and chief executive of BankAmerica, says he was "incensed" that Keefe lowered his Bank Watch rating to C/D from C, yet left First Chicago's a C.

After his projection of a break-even second quarter led to Keefe's downgrading—but before he shocked the banking industry by instead reporting a second-quarter loss of $338 million—Mr. Armacost asserted in an interview that BankAmerica was stronger than First Chicago by most measurements of financial soundness. First Chicago wouldn't comment on that assertion.

Mr. Keefe, however, says, "I'd be glad to debate Mr. Armacost on that." Noting that his downgrading came before the parent of Bank of America reported the huge loss, Mr. Keefe adds, "I'd say Keefe, Bruyette & Woods was a little better tuned into the situation than Bank of America management was. Maybe (the rating) wasn't low enough."

The rating clearly is less important to BankAmerica than to First Chicago. The San Francisco-based bank's California branch system brings in the nation's biggest supply of stable consumer deposits, while First Chicago relies mostly on deposits from institutions. "Bank of America isn't as sensitive," Mr. Keefe says. "They visited me on the telephone. So they lose a few billion dollars (in commercial deposits)—it's not as important."

The CHAIRMAN. Thank you very much.

First, I would ask unanimous consent that a statement by Senator D'Amato be placed in the record.

STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. I commend Chairman Garn for initiating an examination of the important issues regarding the financial condition of the Federal Deposit Insurance Corporation and the Federal Savings and Loan Corporation. The financial viability of these depository insurance corporations has been somewhat eroded due to the record number of failures of the banking and thrift institutions that these institutions insure. The public must have confidence that the FDIC and the FSLIC have adequate resources to insure their deposits in the event of future failures. The success of the banking system since the Great Depression is largely dependent upon depositor confidence, and this confidence has been fostered by the existence of a sound Federal Deposit Insurance System. The erosion of this confidence in our banking institutions and the insurance funds will have drastic consequences for our banking system and our economy.

Due to the far reaching effects the deposit insurance system has on the safety and soundness of the entire financial system, it is the task of this committee to seek recommendations and proposals designed to improve the deposit insurance system. To date, we have heard arguments for and against various proposals to strengthen the deposit insurance system. Some of the proposals before the committee include the merger of the two insurance funds or the implementation of a risk-based insurance system that would impose a variable premium payment program upon banking institutions. Others argue that future problems in the thrift industry could be avoided by taking preventative measures such as providing the thrift industry with more highly qualified supervision from Federal regulators. Another proposal that the Federal Home Loan Bank Board is contemplating would result in the formation of a quasi-Government agency. This agency would buy billions of dollars of troubled assets from FSLIC with loans provided by the 12 Federal Home Loan Banks.

These are some of the proposals that have been put before the committee. I hope that our witnesses will attempt to address the merits and shortcomings of these proposals and suggest alternatives during their testimony. I look forward to the testimony of this morning's witnesses and appreciate their efforts in assisting the committee in its examination of the Federal Deposit Insurance System.

The CHAIRMAN. Gentlemen, I thank you for your testimony.

FUNDS GENERATED FROM THE INDUSTRY

Mr. Cairns, in your statement you make a very important point that is not often made. This point is that Federal deposit insurance are industry-funded pools of resources administered by Federal agencies.

The reason that's so important is that these funds are not taxpayers' dollars. However people may feel about Continental Illinois and the way it was handled, I frankly am very tired of hearing of

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the taxpayers bailing out Continental Illinois or any other bank. So that's an important point you make that should be reiterated. These are funds generated from within the industry, administered by the Federal agencies, and are not taxpayers' dollars and are not costs to the taxpayers.

That procedure is one of the most important reasons that we have been conducting these hearings in attempting to find out if there is some way that we can improve that system. I want to make the point very strongly that any changes we make will not deviate from that principle, that these funds will be gathered from the industry from the institutions. There is no contemplation of using taxpayers' dollars in these funds. That fundamental principle that has always operated will certainly continue, to have industry self-funded deposit insurance, and Federal management of those funds. I guess that's what we're looking at more than anything else. How do we manage them and how do we decide what is a fair way to assess those funds from the industry without using any tax dollars or new Federal subsidies?

Now it's a point that I suppose we will always be saying over and over again and I will still hear that we bail out banks with taxpayers' dollars, which we do not.

Mr. Cairns, with regard to risk-based deposit insurance, you state that banker input would be necessary to design risk-related criteria in order to prevent it from becoming a bureaucratically burdensome form of credit allocation or management second guessing credit allocation.

Will your oversight committee suggest such criteria?

Mr. CAIRNS. Mr. Chairman, we are looking at the subject of risk-related premiums and capital in really two forums. One is in the oversight committee and the second is that committee on safety and soundness that I mentioned that is looking at the whole industry.

On the subject of risk-related premiums for insurance, we have looked at that and frankly we haven't come up with a way that we think would be very effective in discouraging imprudent practices. For one thing, the amount of money charged, or the way that's charged by the insurance agencies, while in the aggregate amount to thousands of dollars per institution, aren't really large amounts of money. And it's difficult for us to see—and we just haven't found a plan that we think is really workable.

We are continuing to look at that and we will have more comment on that, as well as on the risk-related capital, when we have had a little more time to get into it. We have got some studies going on it now and I know we will have information for you in the future.

If I might come back to your comment, though, there was one other point that I tried to emphasize and I'm not sure that I was as clear as I might have been. It seems to us that in the beginning when Congress established these systems 50 years ago, they said that there were two different things that needed to be done. There was support of housing and they established a thrift industry and a fund that that industry would support, and they sent that industry off to do a job which they believed was in the best interest of the public. There was public benefit to be gained.

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They went to the commercial banking system and did a similar thing and said, "you should do these kinds of things because the public needs that service, and there should be this fund that you support to take care of that."

Each did. They went off and pursued their activity. And the problem that we see today is that in the case of the thrifts no one saw the risk that was there. As a matter of fact, I remember very clearly when I first began in banking, mortgage lending was considered to be almost riskless. Hardly did you ever have a loss when you made a mortgage loan to help somebody buy a house, which was the primary thing for which it was originally established. It was later when we saw inflation and we realized the interest rate risk that was there that the trouble really occurred.

Nevertheless, there was a public policy that was fulfilled all during that period of time.

The reason for the problem of the thrifts was because they were single purpose. All they could do was one thing and there was a lot of risk in that.

Well, subsequently, in your judgment, what they could do was changed. It was broadened and they can do many other things now. But that came very late after they were already in the soup, so to speak, and had their difficulty.

It seems to me that in addition to what you said, these are industry-funded programs. Where we are today is we have to learn from the past and we have to provide for the future and hope we don't get into a similar problem. We have to get out of the problem that we have today.

WIDER FOCUS NEEDED

On the commercial banking side, we too were limited in what we could do and we too are struggling today to earn what we need to in order to maintain or assure that the fund is satisfactory. I don't know whether the FDIC is sufficient today in dollar size to adequately handle all the risk that's in the commercial banking system. I think it might be but I don't know that, and I don't know that anybody does. I think only time will tell.

But it strikes me that we need to be careful that the banking system itself is solid and strong and continues to make earnings because that is in fact what's being insured, that the banking system is strong.

We found that it was not strong enough over on the savings and loan side because they were too narrowly focused. I am concerned that we are also too narrowly focused over on the commercial banking side.

And your statements about industry-funded, of course, are very important because were we to try and merge these two, then, of course, what would happen is we would be asking the commercial bankers to pay for all the problems that we have today and I'm not sure there's enough money to do that.

The CHAIRMAN. Well, that is an important point you make, particularly about—you said that they were already in the soup before some of the new things they were allowed to do. I am constantly told privately and in this committee about problems of deregula-

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tion. Yet, as we have examined the failures both in the banking industry and in the thrift industry, we find that the vast majority of them are in trouble because of the good old-fashioned services they have always performed.

Mr. CAIRNS. I think that's the real source of the problem.

The CHAIRMAN. And the thrift industry is making good old-fashioned fixed-rate mortgages not because of any new exotic things they are getting involved in, and that is the point that I have tried to make for a number of years, that you cannot limit the activities of one segment or partial part of an industry while allowing others to get into those same type of services and compete without restriction. That's what this whole battle is about and deregulation is not any wholesale dismantling of Glass-Steagall or repealing it, but allowing some flexibility so that risk can be spread rather than directed into different areas. And that is what has changed dramatically.

So it's another very important point you make that at one time mortgages were considered virtually risk-free. Put your money in that and, boy, you're safe forever. Well, look at the foreclosure rates right now on good old-fashioned mortgages that have nothing to do with investments in any type of new powers granted to any financial institution. Yet, we still have many people who want to hang on to 50-year-old laws or parts of 50-year-old laws on the basis that that was good enough then and it's good enough now. Well, the world has changed rather dramatically and that's what this committee has been trying to explore for a long number of years now—explore those changes and how we relate the banking laws of this country to the changed economic conditions of this country, which have changed.

Mr. CAIRNS. Right.

The CHAIRMAN. So where you find the opposition coming from is people who like the protection they are getting and the unfair advantages because of Government regulations restricting others. That's what it fundamentally comes down to. I'm naive enough to think the opposition will go away. It won't. And people will come in here and say, "Yes, that's fair." That's never going to happen in my lifetime or yours or my kids or anybody else.

Mr. BACKLUND. Could I make a brief statement in a broader perspective about what we're talking about—the problems in the banking industry and the farm credit system and so on.

I think we should realize that these problems can be traced to the inclination of Washington and the administration and Congress and so on—not the inclination but the failure to come to grips with the fiscal side of our financial system because this debacle in the savings and loan industry happened as a result of the Federal Reserve tightening up the monetary policy and then the fiscal side wasn't corrected at the same time. Until we get that, we're going to continue to have these kind of very serious problems and I think that lawmakers here in this city should realize that that is a very important ingredient in solving these problems.

BUDGET IS A HOAX

The CHAIRMAN. Well, I will spare you and all the people out there who sit through every one of these hearings my speech on fiscal responsibility. They've all got it memorized anyway—and the irresponsibility of Congress. I will just stop by saying you're absolutely right. We control that, get that under control, and we would solve a lot of these problems we are struggling with in other legislative areas. But when you've got people that haven't got the courage to pass a reasonable budget—and I will only add that if you think we have a budget resolution that saves $55 billion, you believe in the tooth fairy too. We passed a budget of smoke and mirrors that is not real and is a hoax on the American people because Congress didn't have the guts to pass a real budget, and we will be back in a continuing resolution. If you think we're going to pass appropriation bills or many of them between now and the first of October, you believe in double tooth fairies.

Let me follow up, Mr. Cairns, with one more question about risk-related capital. Some banks already have a system of internally allocating capital to each of its operations based on levels of risk and the amount of activity. Is your oversight committee going to be able to look at some of those banks that are experimenting with this kind of allocation and see how they're doing?

Mr. CAIRNS. Yes, we are. As a matter of fact, one that has taken quite a lead in this internally within the organization has been the Bankers Trust Co. of New York and they have agreed and have actually delivered to us their formulas and thoughts on it. We also have consultants who have looked at other banks and we're comparing all of this now to see what the factors are and how the formulas work and what kind of results might be achieved and so forth.

I said in my formal written comments that we are concerned that we proceed slowly and deliberately on this because there are a lot of pitfalls and there are some things that stand out right away that risk-related capital, for example, could be misused. In other words, if you make loans to certain groups of people or under certain conditions, then your capital would be less, for example. It could be very politicized and build into the system a lot of risk that none of us would like to have.

So we are concerned that those kind of things not be put into any system.

But I think you need to come back for the purpose of this deposit insurance thing and go back to the one proposal we did—the one or two proposals we made in our comments. And that is, if we have the modified payout plan, then it lets the market come at this problem in a different way. If it is known that no matter where you have your deposit if it's over $100,000 and there's a failure you will lose—there's no question about another Continental being repeated—you will lose, that puts a discipline, and it puts the discipline in the hands of people who have large deposits. And generally, those are sophisticated people who then know how to interpret the data that we already are disclosing. And we would not object to disclosing more data for that particular audience if it was required.

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We really think that there is enough data out there now for them to make a proper assessment of the health of an organization, but if there's some other data that is necessary we would be happy to supply that.

The point is that there is some need for market discipline and the best way we think to do that is to put people's feet to the fire and the modified payout approach does, of course, accomplish that.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you, Senator Garn.

I have enjoyed your testimony, both of you, and you have been able to condense the broad picture and I find very, very little I can argue with on the total picture. I also agree with you, Senator Garn, on what you're saying about the deficit. I could not agree more.

There are a couple of points I want you to elaborate on a little bit more and I'm glad you brought it up, Mr. Cairns. You brought up honesty. I look at the different banks that are failing and I see the loans, the portfolios. It's either absolute stupidity or dishonesty. And I'm glad this is being brought out. And also the directors and officers liability. How do you feel about that? Should we push that more?

ZEROING IN ON FRAUD AND DISHONESTY

Mr. CAIRNS. Well, I think as far as pushing it more is concerned, I believe that the mechanics are there to do the proper job. We have the Federal Reserve with examiners. We have the FDIC with examiners. We have the Comptroller's Office with examiners. But I'm not convinced in my own mind that they are zeroing in on this subject of fraud and dishonesty as quickly and as hard as they might do that, and I think that a real stimulus to them to use the tools they already have might be very much in order because I, too, agree that we have seen some cases of flagrant violations of laws and regulations and they were there for some time before they were discovered. And I would just suggest--I don't know that it takes more laws. I think we have the tools already, but we need the encouragement to make use of those tools.

Senator HECHT. But a regulator can only report things, which he does, and he comes back at a specified time and goes back again and if it's still delinquent or documentation or something is not there, certainly these directors of these institutions have to have accountability. Don't you think so?

Mr. CAIRNS. Oh, yes, and again, of course, as you well know, all across the country where there have been failed institutions, there are lawsuits now pending against officers and directors to ascertain what their liabilities really are in the court system and many of those cases are yet to be heard but will be in the future.

But I don't know that I can agree with the concept that we're stepping up as quickly as we can. I differentiate between the situation where there's a loan made and there's a lack of documentation and where there's a loan made that just is an absolute fraud or a misuse of bank funds. I think the two are not synonymous.

Senator HECHT. But it's just a total picture, if you don't carry out all these steps then there's more leeway to fraud. In other words,

there are certain procedures you follow and if you don't follow these, then you open it up.

Mr. CAIRNS. Well, that's true. If a bank is examined and all of its records are sloppy and the documentation is poor, then obviously there should be a concentrated effort, in my judgment, on the part of the regulators, supervisors, and examiners to zero in and really come down hard on that board of directors and on the management and get those problems corrected and if they feel it can't be or won't or isn't proceeding with absolute diligence, then I think they already have the tools to remove management and remove members of the board as far as that's concerned or close the institution.

I think they are sometimes too slow in exercising those capacities that they have and I believe they should be encouraged to accelerate that where it's appropriate.

On the other side of the coin, I think it's also important to note that the banking business is a complex business. It does take time sometimes to correct errors of documentation and so forth and so I think prudence has to be used in terms of not overreacting. But where there is actual evidence of fraud, then I think action should be taken quickly.

Senator HECHT. Do you want to comment on that, please?

Mr. BACKLUND. Many, many years ago I was a bank examiner, so I've had some experience in this, and my experience as a banker also makes me pretty certain that bank examiners do not act quickly enough, forcibly enough, and that we should have people involved, especially at the top, who really can identify and see who the bad actors are and come to grips with them very quickly. I hate to see this trend of suing directors of failed banks because it creates a tremendous problem for the good banks out there. It's very difficult now for smaller banks to get D&O insurance. It's very difficult to get bankers' blanket bond. I would rather see it done early on so that we identify and get these people out who really shouldn't be in the banking business, get them out early, and that I think has been a real failure of the system. And I really blame the regulators more for that than anyone.

Those types of people have to be dealt with very forcibly and bank examiners have difficulty doing that. Bank examiners generally are very good at nit picking in the banks, small little items, detail items. But when it comes to really serious problems, the mentality seems to back off. And that's from my experience as a banker and as a bank examiner.

Senator HECHT. Well, deficiencies occur very simply. It's not 30, 60, and 90 days. It's very easy to point out real fast where the problems are and you've got to start working. And I just think the officer and directors——

Mr. BACKLUND. The good people do, the people who are really good bankers and concerned, they do react.

Senator HECHT. They do that and you only know about the 14,500 commercial banks operating, but a very few of them are causing the problem for the rest of them.

Mr. CAIRNS. Well, I do think it's difficult to quantify. You just threw some numbers out—30, 60, and 90 days. It is a complex business and it is very difficult, if not impossible, to say, "Here's a formula and if you follow this formula everything is going to be won-

derful," or "You must follow this formula or we're going to run you out."

There are some judgments that have to be applied and I think that's what Chip is talking about and certainly that's what I'm talking about. There needs to be some judgment on the part of the examiners when they examine a bank as to whether there's fraud here—now that can be documented if there's actual fraud—and as to whether this organization is functioning properly and represents an undue risk or does not.

I think it's impossible to legislate a formula, but it's not impossible to train examiners to use judgment together with certain techniques for identifying potential risks. I mention in my prepared testimony that there are all kinds of computer techniques now to identify potentials and then you have to go in and examine those potentials and see what the situation is and then use some judgment. And that requires more training than some of the examiners have, more sense of urgency in some cases, more ability to step up and call a difficult shot. I would question if I were in your shoes whether the insurance agencies have the capacity to acquire enough people who can possess that kind of judgment and talent to do the proper job. You need to look at things like the salary levels and the ability to attract good solid people who have this kind of foresight to the industry.

Those are issues that I think are somewhat detailed but I think they are important in the overall investigation you're making of the ability of the funds to perform and satisfy their responsibilities.

Senator HECHT. We've already discussed that many times in the last couple of years and they say they do not have adequate funding for supervisors and they need more and they do not have adequate funding.

Let me get off of that. Mr. Backlund, you mentioned brokered deposits, the problems, but I did not get a significant answer from you on what you feel should be done about it.

ELIMINATE INSURED BROKERED DEPOSITS

Mr. BACKLUND. Well, if it were up to me personally, I would eliminate FDIC insurance on all brokered deposits. That's my personal prejudice. I think it's very bad basically for the system. I don't think it was ever intended, like I said, for FDIC insurance to protect sophisticated investors who are investing through brokers. I think it was intended to protect the little old ladies in tennis shoes from Peoria. That's my view of it.

So as far as I'm concerned, I think it should be legislated out, if I had my way.

Senator HECHT. I appreciate your frankness.

Would you address that, Mr. Cairns?

Mr. CAIRNS. I would say the same thing.

Mr. BACKLUND. One of the things in the other discussion that I wanted to mention is that these problems we have in dealing with these problem banks—I think depoliticizing that I mentioned is very important in that because there's a lot of politics involved in trying to deal with these problems. You might look at the situation in Tennessee, for instance. I wasn't privy to that, but I suspect that

there were a lot of political pressures involved when they tried to deal forcibly with that. And that's why I think the regulatory system, the insurance system, should be depoliticized as much as possible.

Senator HECHT. That's exactly what Senator Garn was saying. If you believe that's ever going to happen, you believe in the tooth fairy. Of course, it's not going to happen. Every time we have a problem, politics rears its ugly head.

Mr. BACKLUND. If you're going to be optimistic about these things you've got to believe in the tooth fairy.

Senator HECHT. With that, my time is up.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Gentlemen, on July 23, during one of our hearings I asked Mr. Isaac, who is the Chairman of the FDIC, whether Congress should stipulate that the FDIC should be allowed to examine any insured bank without being required to get permission of the other banking agencies.

Mr. Isaac replied in part:

> If you can enact legislation giving the FDIC unfettered authority to examine any institution it insures, I believe that would be the appropriate thing to do.

FDIC AUTHORITY TO EXAMINE BANKS

First, Mr. Cairns, do you think we should give the FDIC clear authority to examine any institution it insures and, if not, why not?

Mr. CAIRNS. Well, Senator, I think it is important that the FDIC have the information necessary to do the job that it's supposed to do. I am not convinced in my own mind that it's necessary for them to have their own examining team going in and duplicating the examinations that have already been performed by other Federal agencies, either the Federal Reserve or the Comptroller's Office.

It seems to me that that is an unwise use of Federal money and it's an unwise use of bank's time to have the same examination done over and over again by just different agencies.

I'm not opposed to the information being transmitted. I think if the FDIC is not making the examination but has some special requirements or special things they would like to have looked at, they could ask and should be permitted to ask whoever is making the examination to provide that information for them.

Senator PROXMIRE. Why shouldn't they be allowed to go ahead if they feel that just from a strictly insurance standpoint—that's their one function?

Mr. CAIRNS. It's just a question of the use of resources on both the part of the bank and also on the part of the Government. There is nothing magic about an examination. You have an individual. It doesn't really make any difference whether he's hired by the Fed, or the Comptroller, or the FDIC. If they're trained properly, they can go in and get the information and provide it back to the agency that needs the information to go forward with it. Why do it twice or three times? Do it right the first time and get the information back so action can be taken.

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Senator PROXMIRE. Well, the reason why, I presume, is because they have the insurance responsibility and the other agencies do not.

Mr. Backlund, do you have an opinion on this?

Mr. BACKLUND. Yes; I do. I can see Jim's point. However, if I were doing it, I would err on the side of letting the FDIC in if they were concerned. They, after all, are insuring the deposits and if they have a concern they should be allowed to go in, I would think.

Senator PROXMIRE. Mr. Backlund, during his testimony on July 23, Mr. Isaac said:

> Our present system of bank regulation and thrift regulation is unwieldy. I think we have too many regulators.

He noted, for example, that if there was not so much disagreement among the regulatory agencies higher capital standards could be implemented administratively, but because of disagreements it did not appear to be likely in the absence of congressional direction.

Do you agree with Mr. Isaac that our present system is unwieldy and, if so, do you agree that we should consolidate the three banking agencies into one independent agency as I've advocated over the years?

Mr. BACKLUND. Well, I can agree that it is somewhat unwieldy. I have a problem with the consolidation because I have the fear that if you had some very obnoxious regulator to a certain group like the community bankers that they would be stuck with that and they would have no alternative. So I like the idea of the alternatives that they have today between the FDIC, the Fed, and the Comptroller.

But I understand the reasoning behind it, but that's the reason that I do not support it.

Senator PROXMIRE. Your industry is the only industry I know of that has this unique ability to choose your regulator. As you know, Arthur Burns called it "competition in laxity." Whoever is the most permissive, the easiest, is going to get the business and have the jurisdiction. Don't you see that that is a problem?

Mr. BACKLUND. Yes; but I think it's a luxury that I would hate to give up. [Laughter.]

Senator PROXMIRE. Well, bless you. That's one of the few frank answers I've gotten on this issue.

Mr. Cairns, how do you feel about this?

Mr. CAIRNS. As you know, Senator, there's been a Bush task force effort to look at this very subject of combining the agencies and I understand that there may be hearings on that subject in the future and we have quite a bit of material we would like to share with you at that time.

Senator PROXMIRE. Of course, you've just told me in your answer to the previous question I asked that you feel we should economize as much as we can and I think you're right, on regulatory operations we should not duplicate regulation. So I would think on that principle that it would be sensible to try to consolidate the agencies.

Mr. CAIRNS. In some of the functions, absolutely. There are some qualities to the system we have which we think are worthy of pre-

serving because they are in the public's best interest. Of course, that gets into a lot of detail and I don't know if I can give you all of those today from memory, but I would be happy to respond to that in a formal way any time you suggest.

Mr. BACKLUND. Senator, could I make just one more comment on the consolidation?

Senator PROXMIRE. Yes, sir.

Mr. BACKLUND. One thing I think we need to realize is the tremendous difference between the Bartonville Bank and a bank the size of Continental, 1,000 times larger than the Bartonville Bank, and the Bartonville Bank ranks like in the top 6,000 banks in size in this country. So there's a tremendous difference. They are almost not even the same animal—the little community banks and the giants of the industry.

So I have the fear that if you had one agency, the political power of the biggies would necessarily dictate who was running that agency and that the smaller community banks would be at quite a disadvantage.

Senator PROXMIRE. I understand that. Other industries that are regulated, of course, have similar differences in size and so forth.

Mr. CAIRNS. Senator, before you leave that, one thing that—and I don't know how far your thinking is running in terms of efficiencies and consolidations and so forth, but one of the questions that was raised recently was that of the dual banking system itself and whether there should be State chartered versus federally chartered and the Federal insurance and all those kind of things.

DIVERSIFICATION ALLOWS EXPERIMENTATION

I think that as part of the discussion and part of the thing that needs to be thought about very carefully, that we do have a very large and a very diverse country, and if we centralize it too much, if we allow all the rules to come from Washington and apply to all, then any time we want to experiment or try something we run a very big experiment. But if we allow States to take off in certain directions, those experiments can be limited in size, limited in risk, limited in scope, and if they prove out well can be expanded, and if they don't they can be terminated without the effect that you would have if you had the whole country involved in the experiment.

So care needs to be exercised in the process of thinking out the ramifications of consolidation, but there are other areas that you could move forward I think and have benefit for all.

Senator PROXMIRE. I think that's a very good point on the experimental value of differentiating. I don't think that necessarily would preclude the notion of having a single regulator, however.

Mr. Cairns, as you already know, on May 6, the FDIC unanimously adopted a new policy of disclosure which has a delayed effective date of January 1, 1986. Under the new policy, FDIC will disclose by a press release or other vehicle the names of institutions or individuals against whom final enforcement actions are levied.

One problem with the new FDIC policy, however, is that it only applies to State chartered, non-Federal Reserve member banks. It

does not apply to national banks, Fed member banks, FSLIC-insured institutions, or credit unions.

So a depositor might, because of an FDIC disclosure, move his money from a State bank to a national bank or thrift that may in fact be a weaker institution.

Don't you think this is unfair and possibly misleading to the public and shouldn't all the regulatory agencies adopt an FDIC disclosure policy so the public can know which institutions are not being operated safely?

Mr. CAIRNS. Yes and no. Yes, I think it's unfair; and no, I don't think all the agencies should adopt it. I don't think it should be done.

As I said in my prepared comments, I believe that we should move to a modified payout approach where it's absolutely known that if you are the holder of a large deposit—that is, $100,000—and the institution in which you have made that deposit, if it should fail, that you will lose—it's not a situation that the Continental has left us, but the concept and understanding that you will lose—that that will bring to the attention of those who have large deposits the data that's already disclosed with which I think a sophisticated person—and I think it has to be presumed that those that have deposits over $100,000 are at least somewhat sophisticated—would be able to make an informed decision as to whether they want to put their deposit in that institution or not.

I think the aftermath of Continental has left us in the position where most people feel there's no problem and, therefore, they don't look at the data that's already available. I think to disclose, as the FDIC has suggested, either in the form they have or on a broader scale, would only lead to a misinterpretation of the data and possibly could create runs and certainly would be detrimental to the system and to the funds.

Senator PROXMIRE. My time is about up but the chairman has graciously allowed me to ask one more question.

Mr. Backlund, on July 23, Mr. Isaac told this committee that reforms of the banks' supervisory system and the deposit insurance system are the most important issues the Banking Committee can deal with. He said, "Dealing with these issues is more important than the nonbank loophole or geographic restraints or added bank powers."

Do you agree with his views on these and, if not, why not?

Mr. BACKLUND. What were the first two?

Senator PROXMIRE. He said that dealing with reforms of the bank supervisory system is more important than the nonbank loophole or geographic restraints or added bank powers.

Mr. BACKLUND. Yes, I would agree with that very heartedly.

Senator PROXMIRE. Let me add that Mr. Isaac said that the most important thing above anything else we can do to strengthen our financial system is to do something about budget deficits. I presume you agree with that.

Mr. BACKLUND. Yes.

Senator PROXMIRE. Mr. Cairns.

Mr. CAIRNS. We certainly agree with the budget deficit part of that and as far as the other part of it is concerned we think that it's very, very important to make the banks as strong as they can

be, give them the atmosphere and the arena so that they can perform efficiently and effectively and generate good earnings. And with those good earnings, the funds will be better protected than they are now. So we would put, along with looking at the supervisory agencies and so forth, the need to enact product legislation for commercial banks at an equal level.

Senator PROXMIRE. Thank you, gentlemen. I have another question that I will ask you to respond to for the record.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Proxmire.

CONTINENTAL FAILURE

We have talked a great deal about Continental and we do in every hearing. I don't know what witnesses would talk about if we hadn't had Continental fail. It's such a good example of something, I guess. But I want to only go back to it from the standpoint of what I've heard about so much—the unfairness issue—Mr. Backlund, I don't know what the exact number is, but I've heard all the way from 60- to 150-some small banks that were potential failures if Continental were allowed to fail.

Isn't that true of most large banks? You say, "Well, you won't let the large ones fail," but aren't there always a lot of small institutions—without arguing about the number—that would be involved? Certainly in Penn Square, there were a lot of credit unions that were hurt very badly. So doesn't it go beyond just the issue—it isn't black and white, big versus small—they're usually interrelated?

Mr. BACKLUND. Yes. Continental was a special situation and I'm not really critical of how it was handled. It was a very difficult situation. But I really did not quite relate to the statement that there were these many small banks who would fail if the Continental had failed.

The CHAIRMAN. That's why I say I don't know how many.

Mr. BACKLUND. They did mention that as one of the reasons for acting the way they did. I can't imagine a good banker not taking his funds out of Continental if he had perceived at all that there was a chance that it would fail. But all during that period when they were having the run, you had everybody saying—the Governor of Illinois, the Commissioner of Banks, the Secretary of the Treasury—they all said that they wouldn't allow Continental to fail because they didn't want these foreign deposits pulled out of there precipitously and they were concerned about some other major banks who they thought would also have this kind of run. So there was still some money in there, but there were a lot of bankers—and I was one of them—who reduced their deposits at the Continental just as a part of our risk management technique.

So I really didn't buy that argument, to be honest with you.

The CHAIRMAN. Again, that's why I said I don't know where the number is. I didn't buy any particular number. It's just been my experience that you do have small banks always involved with the big ones and yet the issue is always made of absolutely big versus small. And I do know the numbers in the Penn Square situation, particularly small credit unions.

Mr. BACKLUND. But, Senator, they had CD's in there which they couldn't withdraw. The smaller banks had demand deposits and if they had had any idea—if they hadn't had all this reinforcement by key, key people that Continental was not going to fail, they would have had their money out. If they wouldn't have, they were stupid. And, of course, there may be some stupid bankers.

The CHAIRMAN. Mr. Cairns.

Mr. CAIRNS. I know we keep talking about Continental and I don't know that it's all that important to look back except to try and learn from what happened and to try to understand what the ramifications of Continental were. It seems to me that the Continental, for whatever reason and whatever was done, has sent out some signals, and it's those signals that I'm concerned about.

I think the signal is that if you deposit in a large bank you aren't going to suffer a loss, it's too big to fail. And I think that's the wrong signal and it's the reason that the data—we talked about disclosure—disclosure for what purpose? To have the printers have more to print, or to have the accountants more to put together, or to have the regulators have more to look at? I don't think so. I think the reason you want disclosure is so that people will look at this data and make an informed decision as to whether or not this is a safe place to put their money and at the same time I think you're trying to limit the burden of the draw on the fund.

So it seems to me that where we are today is we've got to go back and we've got to change the signal that came out of that and that's why I keep coming back to this modified payoff. We ought to say you run the risk when you have a deposit over $100,000 and you'd better recognize it and you'd better manage your funds. Don't leave it up to you, Senator Garn, to manage their funds. Those funds are owned by somebody and those are the people that should manage the funds. And they need data in order to determine whether the funds are safe and we need to give that to them. But from there on it's their problem.

That's why I think we come back to Continental, not to lambast somebody for what they did, but to talk about the ramifications and those signals.

WRONG SIGNAL HAS BEEN SENT OUT

The CHAIRMAN. Well, I agree with you that the wrong signal has been sent. Obviously, I was not involved in what was done at Continental other than to be informed as it was taking place. In hindsight, it's easy to criticize and I can agree totally with both of you it's the wrong signal. At the time, I do know what a crisis it was, though, and I think under the circumstances at the time, it was handled about as well as it could be because I know that the rumor mill was spreading so rapidly that "Manny Hana" and other large banks—and that could have precipitated an incredible collapse of some runs on some banks in this country that would have had amazing repercussions. It was frightening at the time.

Mr. CAIRNS. I don't criticize that.

The CHAIRMAN. So it's easy to go back and second guess on how it should have been handled. I certainly know that it was a lot cheaper to the insurance fund than just going in and paying off

$100,000 accounts. Also, I know that the stockholders took a $1 billion hit on it and it was not the easy thing that some people portray.

I would even go further, when you're talking about sending the wrong signal—and I was part of it and sat here in this room in the conference on Senator Proxmire's bill back in 1980 and vociferously supported changing the insurance amount from $40,000 to $100,000. In hindsight, I think that was the wrong decision. I think it should have been raised. I think we raised it too high. So you can have a lot of these bad bank situations that people have gotten into things they should not—oh, we've got $100,000 worth of insurance, we'll be covered. So even beyond the issue of uninsured depositors, whether you have a modified payout or not, $100,000 was probably too much. I plead guilty to supporting that and arguing with the House that we ought to raise it to $100,000.

So I think we do have to change the signal and have some market discipline and some way of recognizing that there is risk involved and people ought to be aware of that. I would agree with both of you. The issue of brokered deposits—why should brokered deposits be insured? It was to protect the little old lady in tennis shoes and not the sophisticated investor who puts $100,00 here and $100,000 there and spreads it all over. That's the very purpose of these hearings. Why I got tired of waiting for things to happen on powers and say, well, fine, that's something I wanted the committee to do but in the meantime we can't wait any longer, we've got to take a look at these insurance funds and see how we can send the proper signal and how we can make the system even more sound than it is and how we can put some market discipline out there to stop the go-go operators, because the guilt by association is rather overwhelming as well. It's like in the thrift industry. Overall, the thrift industry is having record profits this year, but that's deceiving to look at that figure because of those that are technically insolvent or not technically—are insolvent if you had normal accounting procedures applied to them. The go-go operators are getting into risky ventures that they simply should not be involved in. The Ohio's, the Maryland's affect the whole depository institution structure. Nobody makes the distinction that they were State-chartered institutions without Federal insurance and all of that and it spreads.

So I think we've got a responsibility to come up with some recommendations of how we can send the proper signals out there rather than the wrong ones that have been sent for some time.

Mr. HEEBNER. Senator, could I just add a comment to your question about the small banks that might be affected in the case of a large bank that perhaps was subject to a modified payoff.

I won't try, from the standpoint of our discussion and our oversight committee, to improve on the description by President Cairns on the market discipline that we would expect—in other words, if it were an announced and understood policy and the uninsured depositors knew they were at risk, we would presume there would be fewer instances where a modified payoff would actually have to occur. But if it did occur and other banks were affected, these presumably are solvent banks, they're faced then with a liquidity

problem, and that's where the role of the lender of last resort comes in.

So we think that's an important part of the picture. To be sure, no matter how much one believes in market discipline—and we do—you still have some butterflies in your stomach as to, well, nevertheless, might this happen; and I think the role of the Federal Reserve is important in dealing with those butterflies.

The CHAIRMAN. Well, I can tell you that I can take a very objective look at this because as long as I'm in the Senate and have seven children I will never have to worry about having a deposit over $100,000. So it's absolutely academic as far as I'm personally concerned.

Gentlemen, thank you very much. We will have some additional questions for your response in writing.

[Response to written questions from B.F. Backlund, and James G. Cairns follow:]

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B. F. Backlund
President
Charles T. Doyle
President-Elect
Thomas H. Olson
Vice President
Charles L. VanArsdale
Treasurer

RESPONSE TO WRITTEN QUESTIONS OF SENATORS GARN AND PROXMIRE
FROM
B. F. BACKLUND

Responses to Senator Garn's Questions

Question 1: Should a federal insurance agency be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed institution with any profit after administrative costs arising from the transaction returned to the original stockholders?

Response: The IBAA supports the concept that the FDIC should be empowered, under strictly limited conditions, to assist banks which are failing but which have not yet become insolvent. This additional power, however, should be structured in such a way that it does not become a means of promoting the cause of interstate banking through the "back door."

Question 2: If the burden of mismanagement were placed squarely on the managers and stockholders and most failures were handled through a purchase and assumption at an earlier stage - immediately or through a conservatorship - regardless of size - wouldn't this dispose of the fairness question as it relates to large and small institutions? Why couldn't a Continental type solution be applied to failing small banks? If an insurance agency is funded totally by institutions is there a federal subsidy?

Response: If most bank failures were handled as purchase and assumptions and all depositors were made whole, regardless of the size of an institution, then it is true that the banks would be treated equally. However, this would, in effect, totally undermine the concept of limited deposit insurance. The IBAA does not seek such a "bailout" for community banks that fail and does not believe that this is the way to address the "fairness issue."

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The deposit insurance funds were established as a form of mutual self-insurance, funded entirely by the affected industries. This basic concept is sound and should be preserved. Congress should take action to dispel the public perception that all bank deposits are backed by the full faith and credit of the U.S. Government.

Question 3: What can be done to prevent covenants in subordinated debt agreements from requiring the FDIC to prevent losses to all creditors as well as the holding company?

Response: In Continental, the FDIC took it upon itself to guarantee the commercial paper issued by the bank holding company, a significant departure from prior FDIC policy and a huge additional burden for the insurance fund. It remains open to question whether the FDIC was legally obligated to assume the liabilities established by the restrictive covenants in the subordinated debt instruments. Whether the FDIC should meet such liabilities is an important issue which Congress should address in trying to limit the future liability of the fund.

Question 4: Is there a place for self-regualtion in the banking industry that draws on the talent within the industry? If so, how could concepts of self-regulation be included in the federal supervisory system?

Response: Governor Preston Martin of the Federal Reserve has spoken out recently in favor of greater self-regulation and peer review within the banking industry, particularly among larger banks. While the IBAA policy committees have not taken a position on this issue, I personally favor an expanded role for banks in policing themselves and shouldering some of the regulatory burden. Peer review is a process which has great

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potential for providing a salutory self-discipline within the industry itself.

To some degree, such self-review already exists. The banking agencies and the industry utilize the Uniform Bank Performance Reports (UBPRs), whereby banks can, and do, obtain copies of other banks' ratings for comparative purposes. These serve a very useful self-regulatory purpose. Developing additional self-regulating steps is a goal which the industry should pursue.

Question 5: What is your view of Mr. Keefe's suggestions that:

a. The current loan limit is too high?
b. Many banks fail due to excessive concentration?
c. A bank be required to list its 30 largest borrowers by type of company?
d. The largest banks be required to supply regulators with monthly data?

Response:

a. The IBAA does not have an official position on this issue, but speaking from my personal experience, I think that overly aggressive use of state lending limits and the exceptions thereto have resulted in a number of recent bank failures. I personally think that the Federal lending limits are preferable to the looser levels set by certain states.

b. Many banks do fail due to excessive concentration in certain segments of the economy; most recently, we have seen an inordinate number of failures among agricultural

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and energy lenders. Such concentration, of course, is not so much a matter of choice by the lenders as a reflection of the local economies where dependence upon one or two industries is largely unavoidable. Again, if the bank regulatory agencies carefully moritored banks under their supervison, as certain segments of the economy weakened, these loans would not endanger the viability of the banks.

c. The IBAA opposes any public disclosure of the identities of a bank's largest borrowers. General information about the percentages and types of loans contained in a bank's loan portfolio is already made available to investors through the quarterly call reports. Any additional disclosure would constitute an invasion of privacy for a bank's borrowers and would not serve any compelling public interest.

d. The IBAA, in limited situations, would support agency requests for monthly data if such information were needed for safety and soundness purposes. For example, we have supported the FDIC's request for monthly reports on brokered deposits. The agencies already have the authority to impose such requirements without additional Congressional action.

Question 5: Should CPA audits be required of all depository institutions and their holding companies? What steps, if any, should be taken that would permit federal bank examiners to place more reliance on auditor's evaluation of management

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systems and controls? Would this help examiners focus on asset quality, and bank risk levels, etc.?

Response: No. While internal and independent audits can serve a very useful purpose in detecting a bank's problem areas, a certified audit may often be an unnecessary expense or outright waste of money. Bank regulators generally do not rely on audits in performing their examinations, undoubtedly because many of them have proven to be of questionable value (e.g. Penn Square). The audit function for a small bank can be more efficiently met by independent auditing specialists, internal audits, and cooperative auditing teams organized by peer banks. These options should not be foreclosed by legislating a CPA audit requirement.

The Comptroller of the Currency has been considering for some time a requirement that all national banks undergo independent audits. Many institutions, including all publicly owned banks, already undergo such audits. We suspect that one reason the OCC has been reluctant to impose such a requirement on all banks has been the agency's realization that such audits would impose an extremely heavy financial burden on small banks. Again, this is perhaps an area which the banking agencies should address jointly, through the FFIEC, without need for Congressional action. However, Congress should possibly consider granting the agencies additional authority to set audit standards and to discipline accounting firms which perform incompetent or fraudulent audits.

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Question 7: Would you recommend that federal depository agency personnel be exempted from government pay ceilings? If so, how can this be effectuated?

Response: Appropriate steps should be taken by Congress to provide better pay and working conditions for bank examiners. Since the various regulatory agencies are set up differently under the federal budget, different arrangements may have to be made to enable them to hire and pay examiners at a level commensurate with their responsibilities. Incidentally, I would make the personal suggestion that the agencies would be wise to tap the reservior of experience and knowledge within the retired banking community to assist examiners.

Question 8: What is your view of permitting federal regulators to require institutions to pay special assessments for the increased examinations made necessary by their classification as a problem institution?

Response: In many ways, there is no difference between levying a higher risk-based insurance premium on problem banks and levying a special assessment against such institutions for increased examination costs. The FDIC has included a special assessment provision in its discussion paper on risk-based premiums. Although the IBAA has endorsed the concept of risk-based premiums, its policy-making bodies are still in the process of reviewing the FDIC's proposal. We will be happy to share our final comments with the Committee in the near future. I personally think, however, that such special examination assessments could serve as a fair and readily available tool for the regulators to use in problem banks.

Question 9: How can the bidding process be improved and the cost of managing a failure reduced?

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Response: The IBAA continues to hear a number of complaints about the bidding process in failed banks, particularly about the frantic nature of the bidding and how many well-managed and conservative institutions do not have an adequate opportunity to bid. Congress should consider setting minimal guidelines which guarantee a more orderly and equitable bidding procedure.

Question 10: Should federal regulators be given any exemption from the burdens of the Paperwork Reduction Act? If so, when should they be exempt?

Response: The IBAA is not in a position to respond to this question. Perhaps the agencies would be better prepared to address this issue.

Question 11: If regulators are rarely surprised by a bank failure - isn't the answer swifter or more appropriate regulatory action rather than increased market discipline? Wouldn't giving the regulators the ability to close an institution earlier be appropriate? Should a regulator require bank management to file a confidential bank failure plan approved by its board of directors if it falls a certain percentage below its minimum capital level for a specified period of time?

Response: There is no question but that the bank regulators often allow problem banks to deteriorate over a long period of time without taking strong enforcement action, particularly against insider abuse. In such cases, more frequent on-site examinations and more stringent enforcement actions would be warranted, including forcing directors to become more directly involved in the day-to-day management of problem institutions. There is no indication, however, that the agencies need any significant new statutory authority to deal with these problems,

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either by closing institutions earlier or by requiring banks to prepare contingency bank failure plans.

In addition, I would reiterate my contention that problem banks would be handled more effectively and more swiftly if the regulatory agencies were depoliticized and managed by people with "hands on" banking experience.

Question 12: What percentage of total bank earnings are paid in deposit insurance premiums each year? Has this percentage gone up or down over time? Is there much variance bank to bank or by size of institution?

Response: The bank regulatory agencies possess more definitive statistics on earnings/premiums ratios than we do. However, we have information suggesting that insurance premiums constitute roughly 8% of industry earnings. In addition, small banks pay a higher percentage of their earnings for insurance than do banks with large amounts of foreign deposits. Sixteen percent (16%) of all deposits in this country's commercial banks are foreign deposits and these depositors are receiving de facto deposit insurance, free of charge.

Question 13: There appears to be strong support for required risk-based capital - as a method of calculation of capital or as a supplement to the flat rate capital ratios. Would this necessarily lead to higher capital standards? Is there any need for legislation in this area if such risk-based standards were to be applied equally to all institutions?

Response: As we made clear in our September 10 testimony, the IBAA has serious misgivings about the FDIC's proposed 9% net capital requirement, with 3 percent in the form of subordinated debt. The risk-based capital approach, as formulated by the OCC and the Federal Reserve, appears to be much more flexible and

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fair. At this stage, it does not appear that legislation is needed on this issue.

Question 14: In 1981 and 1982, the banks and thrifts were suffering from disintermediation - their better customers were flocking to money market funds in droves. Now the concern seems to be that the higher quality loan customers are able to fill their needs elsewhere. The banks point to commercial paper, and the securitization of their loan portfolio. They claims that this trend is being caused in part by their capital ratios and reserve requirements. What is your view? What recommendations do you have for us in this aread?

Reponse: The Committee correctly notes that there is a continuing movement away from depository institutions in supplying corporate funds. This movement underscores our longstanding concern over the need to compel all deposit-taking institutions, such as money market mutual funds, to meet the same reserve requirements that banks must meet. In addition, banks would be in a better position to obtain cheaper funds and become more competitive if deposit insurance only covered FDIC losses only up to $100,000 per depositor. This would enable the FDIC to increase its rebates to banks and would moderate the need for higher capital and reserve requirements.

Question 15: With regard to the concern that some states may have expanded banks product authorities beyond what may be prudent, can this issue be dealt with by giving the federal insurance agencies the authority to require a prudent level of capital to support that activity in order to maintain insurance - rather than giving any federal agency the authority to override a state legislature? In other words, wouldn't the adoption of risk-based capital standards go a long way toward solving this problem?

Response: It is true that the federal government--through the Federal Reserve or similar agency-- should have the final authority to determine whether certain types of activities by state-chartered financial institutions are so inherently unsafe

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or unsound that they must either meet higher capital requirements or be denied deposit insurance. This problem does need to be addressed. However, the IBAA's policy-making bodies have not yet had an opportunity to consider the issue of how the federal government should exercise this authority. In the meantime, the Federal Reserve should continue to scrutinize closely the activities of bank holding companies to make sure such activities are property related and incidental to banking.

Question 16: Mr. Isaac has stated that a significant number of bank failures are caused by fraud. Other than increased enforcement actions which are being taken by the federal agencies - aren't Mr. Homan (Former Senior Deputy Comptroller for Bank Supervision, Office of the Comptroller of the Currency) and Mr. Ryan (Former Director, Division of Banking Supervision and Regulation, Federal Reserve System) right as to the importance of the ON-SITE exam to ascertain the integrity of the numbers being generated and the lack of fraud? If so, does the decrease in on-site examinations bring with it an increase in the risk of fraud? If so, how can this be corrected?

Response: Yes. The IBAA strongly supports more frequent on-site examinations, particularly for problem banks, and a renewed emphasis on audit techniques that focus on a bank's internal controls.

Question 17: Even though the FDIC continues to grow, how can or should we determine if the size of an insurance fund is sufficient and will continue to be sufficient?

Response: The FDIC fund is strong and growing. However, since the fund has taken on major new responsibilities, such as assisting Continental Illinois, any thought of restructuring is premature. Once needed reforms are put into place, including charging premiums on foreign deposits and off-balance sheet liabilities and limiting the liability of the FDIC to protect all

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creditors of failed banks, then the appropriate size of the fund can be determined.

Question 18: In your opinion, what are the advantages and the disadvantages of risk-based capital and risk-based premiums? Should we consider one or the other or both? Why?

Response: See our September 10 testimony. At this point, the IBAA is continuing to study various proposals on risk-based premiums and risk-based capital. As we formulate more detailed positions, we will share these with the Committee. It is important, however, for the agencies to allow a long phase-in period for banks to meet these additional requirements.

Question from Senator Proxmire

Question: As you may know, I introduced an amendment to last year's banking bill to include foreign deposits in the FDIC's premium base. I believe this is required in order to be fair to community and regional banks. Many of the large money center banks have half or more of their deposits in their foreign branches and pay no premiums against these deposits even though they are 100 percent de facto insured by the FDIC.

Do you agree that we should include foreign deposits in the FDIC's premium base?

Response: As we noted in our September 10 testimony, the IBAA strongly supports the inclusion of foreign deposits in the FDIC's premium base. As noted above in response to Question 12, it is unfair that community banks are forced to pay insurance premiums based on 100 percent of their deposits, while the large international banks have to pay premiums based only upon their domestic deposits. Since the large banks' foreign depositors are receiving the same insurance protection as their domestic depositors, the banks' premium base should reflect the additional liability.

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Questions for Mr. Cairns (ABA) from Senator Garn

Q. 1. **Should a federal insurance agency be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed institution with any profit after administrative costs arising from the transaction returned to the original stockholders?**

A. The current system of examination allows the federal regulators to monitor the financial condition of depository institutions, with the goal of reducing the number of bank failures. It also allows the chartering agency to limit losses to the insurance fund by promptly closing insolvent institutions. In theory, the FDIC need never make a payout from its insurance fund, and uninsured depositors and creditors need never take a loss, provided that the regulators close each failing institution at the exact moment of economic insolvency. In reality, however, the regulators are unlikely to be able to pinpoint the exact moment of insolvency without incurring extensive monitoring cost.

In any decision to close an institution, the chartering agency faces two possible errors. First, if they wait too long the net worth of the institution may become negative, thus imposing larger than necessary losses on the insurance fund, and on uninsured depositors and creditors in the case of a traditional or modified payoff. On the other hand, if they close the institution before zero net worth is reached, unnecessary losses will be imposed on shareholders and on bank management. In addition, there are real costs involved in closing a bank, including the administrative costs of the regulators, and the transition costs involved in establishing new management unfamiliar with the bank and the bank's customers.

The concept in your question -- allowing the chartering agency to close a bank before economic insolvency is reached -- would protect the insurance fund by allowing greater leeway to err on the side of closing an institution that is not insolvent. This situation would essentially create a tradeoff between increased shareholder discipline and decreased depositor discipline. To the extent that uninsured depositors believe that the regulators will always close an institution before it reaches zero net worth, depositor discipline would be significantly diminished even if a modified payoff procedure were in place. Essentially, such a system would create de facto 100% deposit insurance.

Shareholders are at risk under the current system; clearly, shareholders' risk would be greater under the scenario in your question because the value of their assets could be significantly reduced while the institution was in fact still solvent. The regulatory burden on the banking industry has already depressed bank stock prices relative to other industries. The increased risk this scenario would impose on bank stockholders would increase the cost of capital to the banking industry by further depressing stock values. It is certainly not clear that the net effect of this tradeoff, i.e., increased shareholder discipline at the expense of decreased depositor discipline, would be increased safety and soundness.

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Q. 2. If the burden of mismanagement were placed squarely on the managers and stockholders and most failures were handled through a purchase and assumption at an earlier stage - immediately or through a conservatorship - regardless of size - wouldn't this dispose of the fairness question as it relates to large and small institutions? Why couldn't a Continental type solution be applied to failing small banks? If an insurance agency is funded totally by institutions is there a federal subsidy?

A. The FDIC has traditionally handled large bank failures through a purchase and assumption transaction (P&A) in which all depositors and creditors are fully protected. On the other hand, some smaller failed banks have been paid out, imposing losses on uninsured depositors and creditors. If a traditional P&A were used in all bank failures, the system would be providing de facto 100% deposit insurance to all depositors at all banks. This treatment would resolve the question of equality of treatment of uninsured depositors at large and small banks. However, as in question 1, it is not clear that the system would be better off. Equality of treatment of uninsured depositors at large and small banks could be achieved without sacrificing depositor discipline by using the modified payoff with a P&A on all bank failures, regardless of size.

Federal deposit insurance is not a free good to insured institutions, nor is it voluntary for a majority of banks. National banks and Federal Reserve member banks must carry federal insurance; in addition, 84% of the states[1] require state chartered banks to have federal insurance. Along with federal insurance comes extensive federal regulation and supervision, including product and service restrictions; the requirement to hold non-interest bearing reserves; and annual insurance assessments on total domestic deposits which fund the insurance system. It is not at all obvious that this system constitutes a federal subsidy.

Q. 3. What can be done to prevent covenants in subordinated debt agreements from requiring the FDIC to prevent losses to all creditors as well as the holding company?

A. Currently, all subordinated debt issued by banks must be approved by the bank's regulator. The approval process would presumably screen out covenants which would inhibit the FDIC in failure resolutions. Bank holding company debt is not subjected to this review process, and in the Continental Illinois situation, covenants to the subordinated debt of the holding company interfered with the FDIC's handling of the failure. While it is not clear whether this problem is widespread, we understand your concern over the issue. A legislative solution could, of course, prevent the issuance of subordinated debt that would tie the hands of the FDIC in dealing with failures. This approach would have transition problems if there is a great deal of subordinated debt with covenant problems outstanding. It is also likely that restrictions on debt covenants would make it more difficult and expensive for bank holding companies to sell such paper.

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1 36 states require all commercial banks to have federal insurance. Another 7 require all newly chartered banks to have federal insurance; some existing institutions may not be so required.

Q. 4. **Is there a place for self-regulation in the banking industry that draws on the talent within the industry? If so, how could concepts of self-regulation be included in the federal supervisory system?**

A. ABA's Banking Leadership Conference endorsed the concept of self-regulation at its meeting in September 1985, and voted to continue working to develop initiatives in this area. One example of how banker expertise can be tapped to increase safety and soundness is the cooperative effort between the industry and the Federal Reserve in devising a system to regulate daylight overdrafts.

ABA has appointed a Commission on Safety and Soundness which will look specifically at the role of banker self-regulation within the overall framework of the industry. This Commission intends to issue a white paper in February 1986.

Q. 5. **What is your view of Mr. Keefe's suggestions that**

a. The current loan limit is too high?
b. Many banks fail due to excessive concentration?
c. A bank be required to list its 30 largest borrowers by type of company?
d. The largest banks be required to supply regulators with monthly data?

A. 5a) ABA supported the increase in the loan limit for national banks from 10% to 15% of capital. Because many states have set a 15% loan limit for their state-chartered institutions, this increase will allow national banks to do business on a more equal footing with their state-chartered competitors. Moreover, the increase enhances the ability of smaller banks to serve loan customers in their communities.

5b) It is not always easy to specify a single cause of a bank failure. Concentration of assets can certainly create problems, as is currently true for some agricultural banks. However, many well managed agricultural banks have handled the situation well, while others have encountered serious difficulties. For example, in 1984 agricultural banks accounted for 71% of the total bank failures. However, the FDIC points out that in each failure "... mismanagement or other factors distinguished the failed bank from other nearby banks that did not fail." [1]

The FDIC cites fraud and malfeasance as the single most important cause of bank failure. ABA supports allowing banks to diversify their product and service offerings as a means of reducing the variability of their earnings. In addition to the obvious benefits to bank customers, diversification of the earnings base would protect against any potential problems from excessive loan concentration.

5c&d) As Mr. Keefe mentions in his testimony, a great deal of information regarding the condition of banks is already available. It is not clear that

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[1] FDIC 1984 Annual Report, p. 14.

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additional disclosure is needed. If a system of market discipline were put in place through the use of a modified payoff, the market would determine how much and what type of information should be disclosed. Those who did not disclose the information that funding sources request would be disciplined by the market.

Q. 6. **Should CPA audits be required of all depository institutions and their holding companies? What steps, if any, should be taken that would permit federal bank examiners to place more reliance on auditors' evaluation of management systems and controls? Would this help examiners focus on asset quality, and bank risk levels, etc.?**

A. ABA estimates that approximately 9,500 banks -- almost 70% of the industry -- are not currently audited by CPAs. We do not believe that the benefits of requiring these banks to undergo a CPA audit would outweigh the costs. However, it might be beneficial to develop an optional system whereby CPA audit data could be used by the regulators as a substitute for some parts of their examination for those banks choosing to undergo an independent audit. Further study would be required to determine the feasibility of this type of substitution. It is possible that some auditors may not have sufficient banking expertise to perform specialized safety and soundness audits. Moreover, the accountants themselves might not be comfortable with what would essentially be a certification role.

Q. 7. **Would you recommend that federal depository agency personnel be exempted from government pay ceilings? If so, how can this be effectuated?**

A. It is vital to the examination process that the regulatory agencies be able to attract and retain qualified examiners. The turnover experience in the regulatory agencies indicates that retention of experienced examiners is indeed a problem. The ABA's Banking Leadership Conference supported better training and compensation for regulatory agency staff at their meeting in September 1985 as a means of addressing the situation.

Q. 8. **What is your view of permitting federal regulators to require institutions to pay special assessments for the increased examinations made necessary by their classification as a problem institution?**

A. ABA's committee overseeing the deposit insurance research project favored the proposal to conduct more frequent examinations for problem banks and to charge for those additional examinations according to time spent in the bank. Essentially, this approach is a form of risk related premiums.

Q. 9. **How can the bidding process be improved and the cost of managing a failure reduced?**

A. The current bidding process poses serious problems only where it is difficult for potential bidders to quickly analyze the condition of the problem bank. In these situations, the proposal to establish a trusteeship to manage the failed bank, with a modified payoff to all depositors and creditors taking place concurrently with the establishment of the trusteeship, would impose immediate market discipline while allowing adequate time for bidders to evaluate the assets of the bank. ABA supports greater market discipline, and is currently studying this proposal.

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Q. 10. **Should federal regulators be given any exemption from the burdens of the Paperwork Reduction Act? If so, when should they be exempt?**

A. ABA does not favor exempting federal regulators from the Paperwork Reduction Act. We believe that the administrative rules of the Act have been helpful in streamlining the collection of data considered necessary to the process of bank regulation and supervision and in reducing the burden of unnecessary paperwork for banks.

Q. 11. **If regulators are rarely surprised by a bank failure - isn't the answer swifter or more appropriate regulatory action rather than increased market discipline? Wouldn't giving the regulators the ability to close an institution earlier be appropriate? Should a regulator require bank management to file a confidential bank failure plan approved by its board of directors if it falls a certain percentage below its minimum capital level for a specified period of time?**

A. The fact that bank regulators are not surprised by a bank failure does not necessarily mean that they can accurately predict each failure. For example, while it is not surprising that a 3, 4 or 5 rated bank fails, many of these problem banks will not fail. The difficulty is to accurately predict which among the problem banks will fail. Giving the regulators authority to close a bank earlier will increase the probability of closing a bank that would have recovered, and will decrease the probability of waiting too long to close a bank with negative net worth; this concept was discussed in the answers to questions 1 and 2. On the other hand, increasing market discipline taps the expertise of market participants in evaluating the financial condition of each institution on virtually a daily basis. If the market judges that an institution is becoming riskier, the most risk averse depositors and creditors will begin to move their funds. This process transmits the market's perception to bank management. As the bank finds it increasingly difficult and/or expensive to raise funds in the market, management must either change its behavior or shrink the size of the institution. The result of continuous market discipline is a more timely response to changing risk conditions at any one bank than can reasonably be expected of bank examiners. In short, the collective judgment of the market will tend to guide funds to well managed institutions and will limit the ability of risky institutions to attract low cost funds.

Q. 12. **What percent of total bank earnings are paid in deposit insurance premiums each year? Has this percentage gone up or down over time? Is there much variance bank to bank or by size of institution?**

A. The following table shows the percent of net bank income paid in deposit insurance premiums 1974 - 1984. The table shows both the basic assessment, i.e., 1/2 of 1% of domestic deposits and the effective assessment, i.e., the basic assessment net of the annual rebate. Both figures clearly show the impact of economic cycles. Most striking is the increase in the ratio of effective assessments to net income since 1980. This reflects both sluggishness growth in net income and reduced rebates due to the number of bank failures.

Year	Basic Assessment Net Income	Effective Assessment Net Income	# of CB Failures
1984	8.7%	8.3%	78
1983	8.5	7.3	48
1982	7.8	7.2	42
1981	7.2	6.1	10
1980	6.6	3.0	10
1979	6.5	2.6	10
1978	7.9	3.6	7
1977	8.7	3.9	6
1976	8.8	3.9	17
1975	9.0	3.8	14
1974	8.8	4.5	4

Sources: FDIC Call Reports, FDIC Annual Reports.

Q. 13. There appears to be strong support for required risk-based capital - as a method of calculation of capital or as a supplement to the flat rate capital ratios. Would this necessarily lead to higher capital standards? Is there any need for legislation in this area if such risk-based standards were to be applied equally to all institutions?

A. It is not clear that a system of risk based capital would result in higher capital standards. Risk related capital is often proposed in conjunction with proposals to expand product and service opportunities for banks or bank holding companies. However, allowing banking organizations to diversify their product line is likely to lead to less variability in income, thus reducing risk.

The most difficult problem with risk related capital is how to measure risk. ABA's Leadership Conference expressed concern over the implementation of risk related capital. There was general agreement that if market discipline is enhanced through the use of a modified payoff, the market will dictate the required level of capital for institutions which fund themselves in the market.

ABA believes that all laws and regulations, including capital standards, must apply equally to all depository institutions. The current situation in which hundreds of thrifts are being permitted to operate with very low or negative net worth places banks at an unfair competitive disadvantage.

Q. 14. In 1981 and 1982, the banks and thrifts were suffering from disintermediation - their better customers were flocking to money market funds in droves. Now the concern seems to be that the higher quality loan customers are able to fill their needs elsewhere. The banks point to commercial paper, and the securitization of their loan portfolio. They claim that this trend is being caused in part by their capital ratios and reserve requirements. What is your view? What recommendations do you have for us in this area?

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A. It is certainly true that the nation's top commercial firms, who were formerly the banking industry's highest quality loan customers, now raise a large majority of their short term funds in the commercial paper market. There is currently more commercial paper outstanding than there are commercial and industrial loans held by banks.

Perhaps the best example of securitization of bank assets is the packaging together of mortgage loans which are used as collateral to issue securities. Approximately thirty percent of all residential mortgages are currently being packaged into mortgage backed securities. Following this example, other instruments such as automobile loans and consumer receivables are being similarly packaged into securities for sale in the market.

Securitization allows financial institutions an opportunity to increase liquidity and reduce interest rate risk. Because it permits a more efficient use of capital, borrowers generally benefit from reduced interest rates. These benefits seem to dictate that the trend toward securitization will continue. We believe that to remain competitive and to continue to serve our customers, banks should have the opportunity to offer full securities services, which would permit banks to underwrite and sell these securities.

Q. **15. With regard to the concern that some states may have expanded banks product authorities beyond what may be prudent, can this issue be dealt with by giving the federal insurance agencies the authority to require a prudent level of capital to support that activity in order to maintain insurance - rather than giving any federal agency the authority to override a state legislature? In other words, wouldn't the adoption of risk-based capital standards go a long way toward solving this problem?**

A. The federal regulators already have the authority to require that banks hold capital in excess of the current minimum capital requirements. However, it is not clear that allowing banks to expand their product line will in fact increase bank risk. Diversification may reduce the risk to the insurance fund by increasing bank profitability and reducing income volatility. While the concept of risk related capital is appealing, we have serious concerns about implementation. ABA favors a reliance on market discipline; if uninsured depositors and creditors perceive that their funds are at risk, they will demand that the institutions with whom they do business be adequately capitalized.

Q. **16. Mr. Isaac has stated that a significant number of bank failures are caused by fraud other than increased enforcement actions which are being taken by the federal agencies - aren't Mr. Homan (Former Senior Deputy Comptroller for Bank Supervision, Office of the Comptroller of the Currency) and Mr. Ryan (Former Director, Division of Banking Supervision and Regulation, Federal Reserve System) right as to the importance of the ON-SITE exam to ascertain the integrity of the numbers being generated and the lack of fraud? If so, does the decrease in on-site examinations bring with it an increase in the risk of fraud? If so, how can this be corrected?**

A. ABA believes the regulators should devote greater resources during the examination process to detecting fraud and insider abuse. However, we do not know if the decrease in on-site examinations will increase the risk of

fraud. Perhaps a reallocation of existing resources and a change of emphasis in existing examination procedures would be sufficient.

Q. 17. **Even though the FDIC continues to grow, how can or should we determine if the size of an insurance fund is sufficient and will continue to be sufficient?**

A. The size of the FDIC fund has increased every year since its inception. Even during the past few years when the number of bank failures has been relatively high, the fund has continued to grow. This experience would seem to indicate that the size of the fund is sufficient.

ABA has recommended increasing market discipline, which we believe will help to protect the insurance fund by strengthening the banking system. Moreover, we believe that allowing banks to diversify their product and service offerings will contribute to a healthier banking industry and thus reduce future demands made on the insurance fund.

Q. 18. **In your opinion, what are the advantages and the disadvantages of risk-based capital and risk-based premiums? Should we consider one or the other or both? Why?**

A. The current flat rate premium structure means that high risk banks pay the same insurance premium as low risk banks. Pricing deposit insurance according to the risk to the insurance fund is intended to address this issue, and to inhibit inappropriate risk taking. There are serious concerns, however, over whether the concept can be implemented in a workable manner. ABA is currently studying the situation, and we will be glad to share our conclusions with you.

ABA also has serious concerns over the implementation of risk related capital. If market discipline is enhanced through the use of a modified payoff, the market will dictate the required level of capital for institutions which fund themselves in the market.

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Questions for Mr. Cairns from Senator Proxmire

Q. 1. As you may know, I introduced an amendment to last year's banking bill to include foreign deposits in the FDIC's premium base. I believe this is required in order to be fair to community and regional banks. Many of the large money center banks have half or more of their deposits in their foreign branches and pay no premiums against these deposits even though they are 100 percent de facto insured by the FDIC.

Do you agree that we should include foreign deposits in the FDIC's premium base?

A. The questions of assessing and/or insuring deposits in foreign branches of U.S. banks raises some very complex issues. ABA has not yet established a position, although it will be a part of our deliberations on the broader subject of safety and soundness.

We believe that including deposits in foreign branches in the FDIC assessment base without extending insurance to these deposits would not be equitable. On the other hand, some serious concerns would be raised by having an agency of the U.S. Government insuring foreign deposits. For example, would it be desirable to have the FDIC insure against political risk?

Including deposits in foreign branches in the FDIC assessment base would obviously have cost implications for American banks doing business overseas. To the extent that the cost of doing business is raised for U.S. banks vis-a-vis foreign banks, the competitive position of U.S. banks will be hurt. A deterioration in the competitive position of U.S. banks would impact our balance of payments and perhaps hurt exports. These issues have significant public policy implications; we believe that any initiative to include deposits in foreign branches in insurance assessments and/or to extend FDIC insurance to these deposits should give these issues very careful consideration.

Your question raises the issue of the perception that all deposits at large money center banks — including deposits at their foreign branches -- have de facto 100% FDIC insurance. It is not clear that the market actually accepts this assumption. For example, it was the large depositors at foreign branches who began withdrawing funds when they became concerned about the health of Continental Illinois.

We believe that the issue of some banks being too large to fail, thus having de facto 100% deposit insurance, could be addressed by using a modified payoff on all failed banks. For those banks that are too complex for immediate resolution, the FDIC could establish a trusteeship to run the bank until a decision on resolution could be made. The modified payoff would take place concurrently with the establishment of the trusteeship. In the case of a failure of an institution with foreign branches, all insured domestic depositors would have immediate access to their funds; all uninsured domestic depositors, all foreign depositors, and all creditors would receive a pro rata share of their claims based on the FDIC's estimated recovery during liquidation. This approach settles the fairness issue between banks and increases market discipline.

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The CHAIRMAN. Now I'd like to invite Mr. Kenneth Albers and Mr. Gerald Levy to the witness table. Would you like to begin, Mr. Albers.

STATEMENT OF KENNETH F.X. ALBERS, CHAIRMAN, NATIONAL COUNCIL OF SAVINGS INSTITUTIONS; CHAIRMAN, PROVIDENT SAVINGS BANK, JERSEY CITY, NJ

Mr. ALBERS. Thank you, Senator.

On behalf of the National Council, thank you for this opportunity to present our views to you.

We certainly agree with what you have said about deregulation a few minutes ago. We do not think deregulation has been at fault in the various bank failures. As a matter of fact, the National Council is rather firmly convinced that nothing could be further from the truth.

OVERVIEW OF BANKING INDUSTRY

What has happened is that the industry has changed a great deal; all sorts of things started happening from June of 1978 when depcsits were tied to outside interest rates. The insurance agencies, however, did not change with the times and this caused some of the difficulties facing us right now.

The only problem with the deregulation in the banking industry is that it came in first on the deposit side and it was a period of years before it came in on the asset side. However, much progress has been made since then and in this current year, savings banks during the first 6 months have earned over $500 million. In fact, we expect that virtually every savings bank in the country will be profitable in 1985 and that hasn't happened since 1979.

On the savings and loan side the picture is even brighter. Through 6 months, they are very close to their all-time record profits for any full year.

With respect to the role of State insurance, we think, if it has a role in the future at all, it will be to supplement Federal insurance. The events in Ohio and Maryland have pretty much assured that State insurance will at best play a limited role.

As for the Net Worth Assistance Program that was initiated in 1982, it has worked and we think should be extended. Now, 30 savings banks have received net worth assistance, 23 are still participating in the program. The other seven were merged into other thrift institutions or were purchased by commercial banking organizations. The 23 savings banks that I indicated, are getting stronger and in most cases have returned to profitability. So the Net Worth Program has bought some time for these banks and it has resulted in lower costs for the FDIC.

For this reason, the program should be extended, at least for those banks presently on it.

The FSLIC side is where we are primarily addressing our comments. There are approximately 1,000 fewer savings and loans in the country than there were in 1980 due to mergers, acquisitions, failures, and the like.

Not only is the FSLIC threatened by these circumstances, but well-managed, profitable members of the industry are also affected

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by weaker institutions. Failing institutions have little incentive to keep costs down by pricing their deposits reasonably. On the asset side, these institutions may underprice their loans, or worse yet, scramble to put high-yielding assets on their books without sufficient regard for proper underwriting standards. So a failing institution is a problem not only to the insurance agencies, but it's a problem to the industry and its banking competitors in the area.

The National Council does not believe the right response is to come back in and regulate at the lowest common denominator. We think broader powers are in fact needed to help the institutions remain viable, profitable, and able to serve the public interest as it is perceived by all of us in this room.

An example of regulating to the lowest common denominator, in our opinion, is the thriftness test where, arbitrarily, every institution must have a certain percentage of its assets in mortgages. We do not think it's proper and we do not think it's sound for many of the institutions in the country.

We established a task force on alternatives to deregulation to look into the problems that the insurance agencies were having. This task force has reported back with a number of proposals to strengthen the FSLIC and in about 1½ hours that report will be presented to the full board of the National Council.

We are recommending various courses of action, none of which need legislative approval so FSLIC could adopt everything we have here if the Bank Board decides to so choose.

SUPPORT RISK-RELATED NET WORTH REQUIREMENTS

We are for risk-related net worth requirements. The council believes that in measuring the risk the focus has to be on the entire institution rather than on the powers themselves. We think you have got to look and see how well an institution has used some of the new deregulated powers.

What is new and deregulated on the Federal scene might not be new and untested on the State scene. The State of New Jersey is an example where we have had a leeway law for better than 10 years and the institutions have used it and used it profitably. Regulating on the basis where the authority comes from is not the way to do it, so we would like risk-related insurance tied into capital and other factors that look at the whole institution.

Right now the regulators have the CAMEL system at FDIC and I think it's termed Macro at the home loan bank where essentially they're looking at various factors and establishing a rating for the banks. This presents a fairer picture. We are recommending that the Bank Board promptly establish a special advisory group which would be charged with the responsibility of developing within 6 months a risk-related net worth requirement based on a whole institution approach.

In our submitted testimony, we have a suggested schedule of examinations; based on the net worth of the institutions and so forth that we will not go into now. Basically, we think institutions with low capital should be required to submit business plans to show how they plan to work out their current difficulties. Obviously, the lower net worth institutions should receive more regulatory atten-

tion, more examinations, and the like, and those examinations should be paid for by the institutions being examined.

We need to review how insolvent institutions have been handled. We think there should be established special purpose corporations in each Federal Home Loan Bank district for the purpose of handling insolvent FSLIC institutions. We think the district by district approach makes sense. First, the people in the various districts know their area better. Second, the direct banks are not subject to the civil service laws, salary requirements and the like. Third, we are just very, very concerned about a gigantic warehouse in one place for all institutions that become insolvent. We think it would become unmanageable. For these reasons, we are advocating such corporations in each Federal Home Loan Bank district.

The purpose of these corporations, is not to preserve the institutions involved, but to marshal their resources, dispose of the assets, branches, and the like so that they eventually are gone from the scene in an orderly manner and with the least cost possible to the FSLIC. There should be a definite time schedule of events and actions which should be followed in dealing with these institutions. Essentially, we think if the regulator feels an institution could be insolvent within 2 years, things should start happening then. If the institution can't solve its own problem within those 2 years and the situation continues to deteriorate, the regulators should step in and try to do it and, if not, move it into one of these warehousing corporations or whatever the name would be.

These companies would have specialized management familiar with real estate and the savings and loan industry so that they know the situation, they know the area, they know the products and they can produce results. Again, the primary function would be essentially to manage the orderly, least cost disposition of the assets and liabilities of the institutions, convert portfolio assets, including real estate, into cash; prohibit new lending unless there's some very, very special reason for it; replace high-cost deposits with lower cost funds; sell branch systems and the like.

I have given you a very terse overview of a plan that outlined in many pages in our written testimony. The National Council feels this plan will work since it relies on early identification of problems, orderly liquidation, and private sector management.

We do not think the industry needs continuing special assessments from FSLIC. When you think about it, special assessments decreases the net worth of the industry and one of the major problems in the savings and loan business is deteriorating net worth.

We do not think the Federal Home Loan Bank Board's overriding State powers is the right answer to the problem. As a matter of fact, these State powers in many cases have been the source of innovation and in the previous questioning period it came out that many times State powers could be used for new products, isolated in an area and then expand nationally. NOW accounts would be such an example.

We do not believe that enacting a thriftness test which limits asset flexibility is going to help the recovery of the thrift industry.

Last, we do not think the two insurance funds should be merged. While FSLIC admittedly has some severe problems, we think a new and different approach to the problems can be most helpful.

Thank you.

[The complete prepared statement follows:]

Statement of

Kenneth F. X. Albers
on behalf of the
National Council of Savings Institutions

Mr. Chairman and distinguished Members of the Committee my name is Kenneth F. X. Albers, chairman of Provident Savings Bank, Jersey City, New Jersey. I am appearing today in my capacity as chairman of the National Council of Savings Institutions, a trade association consisting of approximately 600 savings banks and savings and loan associations with total assets in excess of $430 billion. Our members include both FDIC- and FSLIC-insured depositories; we also represent approximately 80 banks located primarily in the State of Massachusetts which are state insured but are now in the process of obtaining federal coverage.

We are very pleased to accept your invitation to testify on the state of the deposit insurance system. This is a timely subject not only insofar as the industry and its regulatory agencies are concerned, but one which is also very much on the mind of the general public. Last year we witnessed the near collapse of two of the nation's very largest financial institutions, namely Continental Illinois National Bank and American Savings and Loan, the thrift subsidiary of Financial Corporation of America. In 1985 we have seen no abatement in the number of well-publicized problem institutions, including large money center banks, small agricultural banks and thrift institutions of all sizes.

Because the current wave of individual bank and thrift failures has coincided with the industry deregulation mandated by federal legislative and regulatory initiatives launched in the late 1970's, many observers have concluded that deregulation is the culprit. As will become evident in the course of this statement, the National Council is firmly of the view that nothing could be further from the case. The most glaring recent problems have not been caused by the use of newly acquired powers, but by the abuse or imprudent use of long-standing powers.

It is nevertheless true that while the industry was undergoing these truly revolutionary changes, the deposit insurance system has continued to function largely in the same manner that pertained when the activities of

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depository institutions were limited, competition was subdued, technology was static, and nonbank financial institutions were tucked away in their assigned domains. Since it is neither desirable nor feasible to turn back the clock, our task now is to accomplish the necessary deposit insurance reforms that will allow deregulation to proceed in a more orderly manner -- one which permits problem cases to be handled without the loss of depositor confidence that we have seen in all too many instances of late.

INDUSTRY OVERVIEW

Because of the problems which I have just mentioned, I want to begin by taking just a moment to stress that insofar as the performance of the vast majority of thrift institutions is concerned, deregulation is not only working but working well. This is not to say that the transformation to the more competitive banking environment of the 1980's has been an easy one for the industry. Cost-cutting, product realignment, controlled growth, and portfolio restructuring have been the key elements of success in recent years and, as we have seen, management is not in place at every institution to accomplish these difficult tasks.

In large part, the problems which have been encountered are due to the fact that, for thrift institutions, deposit deregulation preceded asset deregulation. Indeed, the repricing of deposits in the first several years of deregulation took place in an environment of record high interest rates and has proceeded throughout a period in which the cost of funds has remained relatively high on an historical basis. Earnings and capital positions at thrift institutions were severely eroded over the period of the last five years, and meaningful progress in rebuilding net worth has really only been possible, on an across-the-board basis, during the last 18 months.

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I am glad to report, however, that conditions have now improved to the point where our Research Department estimates that savings banks earned in excess of $500 million in the first half of 1985. Virtually all savings banks will be operating in the black during the third quarter of 1985, and this is the first time that this has been the case since 1979. The lower interest rate environment has also permitted a growing number of institutions to go to the capital markets for stock conversions and other financial offerings. This combination of retained earnings and new stock offerings has resulted in a marked improvement in industry capital:

CHART I (APPENDIX A)

Annualized Net Change in Savings Bank Surplus
as Percentage of Average Assets, Quarterly

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Calendar Year
1985	.30%	.40%			
1984	*	-.12	.16%	.29%	.08%
1983	-.04	.32	.17	.15	.15
1982	-.92	-.88	-.64	-.35	-.86
1981	-.48	-.76	-1.08	-1.20	-.86
1980	.28	.40	-.32	.04	-.10
1979	.68	.56	.44	.24	.47
1978	.60	.72	.56	.40	.57
1977	.60	.60	.56	.44	.55
1976	.40	.44	.56	.36	.44
1975	.32	.40	.44	.36	.38

* = Less than .005 percent.

Note: Data refer to net changes in surplus, undivided profits, reserves from retained earnings and exclude debentures, capital infusions from FDIC, net worth certificates and net stock issues.

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On the savings and loan side, the picture is even brighter insofar as total earnings are concerned, although there continue to be a fair number of individual institutions which are not participating in the industry turnaround. This is due primarily to problems relating to loan quality as opposed to a maturity mismatch between assets and liabilities which has traditionally been at the core of thrift industry difficulties. Notwithstanding these individual exceptions, we estimate that 1985 will be a record year for savings and loan profits, and that the industry will also make substantial strides in rebuilding its net worth.

CHART II (APPENDIX B)

Retained Earnings as Percent of Total Assets of Savings and Loans 1975–1985

Year	Percent
1975	0.47%
1976	0.63
1977	0.77
1978	0.81
1979	0.67
1980	0.13
1981	-0.73
1982	-0.64
1983	0.27
1984	0.15
1985p	0.34

p = preliminary, based on June 1985 data

MEMBERSHIP IN DEPOSIT INSURANCE FUNDS

State Systems

Thrift institutions have basically had three alternatives for deposit insurance: FDIC; FSLIC, and state-sponsored private insurance funds. The largest private funds are in Massachusetts where both savings banks and cooperative banks (S&Ls) have participated in a state-sponsored system which actually predates the establishment of the FDIC and FSLIC. Other states where savings and loan associations may be insured under private plans include Maryland, North Carolina, Ohio and Pennsylvania.

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These private state funds are in the process of reorganizing inasmuch as their insured institutions in almost all instances have applied for federal deposit insurance in the wake of the Maryland and Ohio banking crises. Even in Massachusetts where the Savings Bank Central Fund has an insurance reserve ratio three times as great as that of the FDIC and the participating institutions have average net worth in excess of 7 percent, market conditions have forced the recognition that it is no longer feasible to conduct the depository business without coming under the umbrella of federal insurance.

The FDIC and FSLIC are processing these applications as best as can be done under the circumstances. The latest data we have been able to develop on the insurance status of thrift institutions show that nonfederally insured institutions have declined from 750 in 1980 to 365 in 1984, to 149 at the present time. At least another 100 of these remaining institutions have already applied for federal coverage, and thus it seems clear that the private deposit insurance option will become a thing of the past for thrift institutions.

CHART III (APPENDIX C)

Thrift Institution Membership in Deposit Insurance Funds, 1945–1985

Year	Total Thrifts	FDIC	FSLIC	State and Other
1945	6,595	192	2,475	3,928
1950	6,439	194	2,860	3,385
1960	6,822	325	4,098	2,399
1970	6,162	329	4,365	1,468
1980	5,076	323	4,002	751
1981	4,740	331	3,779	630
1982	4,249	315	3,343	591
1983	3,912	245	3,183	484
1984	3,774	242	3,167	365
1985p	3,716	283	3,284	149

p = preliminary, based on June 1985 data.

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On this point, your invitation to testify specifically asked us to respond to the question of whether there remains a role for private insurance. As I have indicated, market forces have already addressed the question of private insurance systems functioning as an exclusive alternative to federal insurance. However, it would be our hope that private insurers could continue to play an important supplemental role either as reinsurers or as insurers of deposits in excess of federal coverage. This latter approach has worked well in Massachusetts where depositors have 100% of their funds insured through a combination of the federal government handling amounts up to $100,000 per account and the state system the remainder.

At this point, continuing problems at individual institutions in Ohio and Maryland preclude a firm estimate of the final date when all the nation's thrifts of significant size will have either qualified for federal insurance or found a merger partner. However, the FDIC estimates that it will be the insurer for all Massachusetts savings banks by the end of this month. The bulk of the cooperative banks in Massachusetts, which have also applied to the FDIC for insurance, should likewise be approved by that date or soon thereafter.

FDIC

The Federal Deposit Insurance Corporation has been responsible since its creation in 1933 for insuring savings banks. At this time the FDIC insures 283 stock and mutual savings banks with approximately $184 billion in total assets. It is important to note that the FDIC regulates these savings banks on the same terms as commercial banks as it pertains to capital standards, accounting treatment and all other aspects of the supervisory and examination process.

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Over the last five years the FDIC has devoted considerable time and resources to problems associated with the thrift industry, particularly those savings banks which were most severely impacted by the adverse interest rate climate. There have been 15 FDIC-assisted supervisory mergers involving savings banks since 1980, and in most cases the problem institutions were merged into other savings banks.

In addition, 30 savings banks have participated in the Net Worth Assistance Program established by the FDIC pursuant to the Garn-St Germain Act of 1982. Currently 23 of these institutions are still participating in the program which has been extremely successful from both the standpoint of the industry and the FDIC. Most of the institutions have taken advantage of the additional time to improve their earnings and to begin the process of restoring capital to required regulatory levels. Eight others have voluntarily found merger partners, and three New York City savings banks have recently announced that they have arranged for a major recapitalization through the sale of stock to private investors. Moreover, at least three of the participating institutions have begun to retire their net worth certificates ahead of schedule, and a number of others are expected to follow shortly.

There is no question that the Net Worth Assistance Program has resulted in major cost savings to the FDIC and thereby justifying an extension of the program for at least another three years beyond its scheduled October 15, 1985, expiration date. Given the experience of recent years and the alarming size of present budget deficits, we cannot discount the possibility that we will soon see the return of a higher interest rate environment. If this is the case, then it will be essential to have this proven program in place and ready to go.

Since the height of the thrift crises in 1982, the focus of the FDIC's problem institutions has, of course, shifted from savings banks to commercial banks. As a matter of fact, the $4.5 billion of financial assistance which the FDIC extended to Continental Illinois National Bank is twice that which has been devoted to the entire savings bank industry over the course of 50 years. Were it not for the cost savings realized by deferring action on the problem thrifts by virtue of the Net Worth Assistance Program, a good case could be made that the FDIC would not have been nearly as capable of handling the Continental rescue, the rising failure rate among agricultural banks, and the continuing threat of new financial strains relating to delinquent and/or deferred foreign loans.

Nevertheless, the FDIC has substantial reserves and a steady stream of income from both commercial and savings banks that should permit it to handle all of these potential problems while remaining in strong financial shape. We generally support the reforms which Chairman Isaac has requested in his proposed legislation, S. 760, although we believe that many important remedial steps such as varying capital requirements in relation to risk, can be effectively implemented without waiting for additional legislation.

FSLIC

As the principal insurer of the nation's thrift institutions — approximately 2,800 S&Ls and 400 federal savings banks — the Federal Savings and Loan Insurance Corporation has had to confront an unprecedented proportion of problem institutions since the early 1980's. During the period of the last five years, approximately 1,000 FSLIC-insured thrift institutions disappeared either through merger, purchase and assumption, or liquidation. Many cases had to be resolved with FSLIC financial assistance and, of course, this had to be accomplished without the benefit of off-setting income from a large number of healthy institutions as has been the case with the FDIC. Thus, FSLIC's resources have been reduced dramatically over the last few years.

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Not only is the FSLIC threatened by these circumstances, but well-managed, profitable members of the industry are also affected by the weaker institutions. Failing institutions have little incentive to keep costs down by pricing their deposits reasonably. On the asset side, these institutions may underprice their loans or, worse yet, scramble to put high yielding assets on their books without sufficient regard for proper underwriting standards. Thus, we have a situation today in which the FSLIC is confronted with a substantial number of institutions operating with a thin capital base that creates an incentive for management to make even riskier investments.

The response of the FHLBB to this changeover from dealing with "spread" problems to asset problems has been to embark on a course that can only be described as reregulating the industry. The National Council fully appreciates the monumental problems now facing FSLIC and its parent agency the FHLBB, but we are gravely concerned about this course of action which amounts to regulating to the lowest common denominator. Accordingly, one of my first official actions as chairman of the Council was to establish an industry Task Force to study "Alternatives to Reregulation".

This Task Force, which is is chaired by George Rutland, chief executive officer of California Federal Savings and Loan Association, will be examining a broad range of issues, but its initial focus has been on proposed actions to strengthen the FSLIC. In this regard the task force has benefited substantially from the input of David W. Glenn, a former FSLIC director, who now works at Cal Fed. With the caveat that the Task Force's recommendations have not as yet been reviewed and formally approved by the National Council's Board of Directors, I would now like to highlight the major recommendations that have been developed in the FSLIC area:

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I. Risk-related net worth requirements.

The National Council has officially supported risk-based deposit insurance premiums provided that risk is objectively determined. Moving to a risk-based insurance premium system, however, would require legislation. Accordingly, the Task Force recommends a risk-based capital requirement as a step in the same general direction of providing protection for the insurance funds against excessive risk-taking by insured institutions, but one which can be taken by the FSLIC under existing authority. An additional advantage is that increased capital would strengthen both the institution and the insurance fund. Under the Task Force's plan, higher-risk institutions would be required to have capital ratios above the base requirement applicable to FSLIC-insured institutions generally.

In measuring risk, the focus should be on the entire institution and should seek to rate each institution as a whole in terms of the risk it poses to FSLIC. The system should encompass all types of risk (interest-rate, asset quality, managerial, etc.). It should not be based on whether the institution utilizes powers granted at the state or federal levels, but on the performance and soundness of the institution as a whole.

Examples of the "institution as a whole" approach are the CAMEL ratings (capital, asset quality, management, earnings and liquidity) used by the bank regulators and the broadly similar MACRO ratings used by FHLBB for general supervisory purposes. In utilizing this approach to measure risk for purposes of setting capital requirements, however, ratings for individual institutions should be determined as objectively as possible, using actual experience and "hard" data (balance sheet structure, earnings trends, loan delinquencies, etc.) as well as examiners' evaluations.

Institutions rated as riskier under the approach recommended by the Task Force would be required to have higher net worth in relation to assets. If existing net worth is below that standard, the institution would be subject

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to the following strictures: (1) the institution would automatically be subject to increased and intensified examination at its own expense; and (2) the institution would be required to submit a business plan indicating how it intends to reduce its risk exposure and/or increase its net worth. Progress in achieving these goals would be carefully monitored.

In addition, immediate action would be taken against institutions not meeting their net worth requirements to prevent such institutions from pricing deposits outside of their peer group rate structure. Ultimately, failure to move toward an improved risk-capital relationship or any deviation from the controls placed upon them would expose the institution to cease and desist or removal actions by the regulator. In this respect, as well as in other cases where the situation warrants, the Task Force urges full use of the Bank Board's enforcement authority, which is more than adequate under existing law.

The Task Force recommends that the Bank Board promptly establish a special advisory group which would be charged with the responsibility of developing within 6 months a risk-related net worth requirement based on the "whole institution" approach outlined above. The special advisory group would include industry trade association representatives, insurance experts and other consultants. Formation of such a group would be consistent with the Bush Task Group's recommendation that maximum use of private sector expertise be utilized in developing risk-measurement techniques and Chairman Gray's expressed suggestion that private sector groups make objective and impartial risk pricing recommendations to the Bank Board.

II. Examination and supervision linked to risk-related net worth requirements.

At present, the Federal Home Loan Bank System requires that its members file extensive quarterly reports, and subjects them to a full, on-site

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examination once during a 36-month cycle, with more limited examinations (usually confined to particular functions such as lending standards or futures and forward transactions) on an annual basis. The examination will focus on any of the number of aspects of the association's activities, but will result in a MACRO rating (similar to the CAMEL rating employed by the FDIC) from 1 to 5 that will measure the risk of the institution as reflected in its net worth, earnings, and asset quality.

Institutions failing to meet their net worth requirements are subject to more frequent examination, usually on an annual basis. These institutions are also subject to monthly computer monitoring of certain ratios that have been identified by Kaplan Smith and Associates (under contract to the Bank Board) as identifiers of impending trouble. Unlike the FDIC system, however, these institutions are not always required to file business plans or other such devices aimed at laying out the path the firm will take toward reaching minimum capital levels.

In order to decrease the incidence of problem cases, the Task Force proposes to scale reporting and examination frequencies by levels of risk-based required net worth. In general, well-capitalized institutions will be subjected to current reporting and examination rules, with each examination focusing on several specific aspects of the thrift's operations. As the institution drops below its required net worth level, examination frequency and/or scope will increase, with most intensive monitoring applied to those with negative net worth. One possible schedule is as follows:

> Level 1: Associations with RAP net worth above that required. Semiannual reporting forms will be required with examinations on the regular 36-month cycle and no limited examinations.

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Level 2: Associations with net worth within one per cent below risk-adjusted requirement. Quarterly reporting will be maintained, but full examinations will take place on a 36-month cycle, and limited examinations on a 24-month cycle.

Level 3: Associations with net worth between 1 and 2 percent below requirements. Reports will be submitted quarterly with annual examinations. In addition, monthly computer monitoring of sensitive variables will be maintained.

Level 4: Associations with net worth 2 or more percent below requirements. Reports will be submitted monthly, with semiannual examinations. In addition, monthly computer monitoring of sensitive variables will be maintained.

Level 5: Associations with negative net worth. Monthly examinations; the association will not be allowed to make any significant investment or growth decision without the specific approval of the supervisory agent.

In line with the Task Force's previous recommendation, each institution in levels 2, 3, 4 and 5 would be required to submit a business plan indicating how it intends to increase its net worth and/or reduce its risk exposure.

For state-chartered institutions at Levels 1 and 2, state examinations should be allowed to substitute for federal examinations at the discretion of the federal regulator. This would have the effect of conserving FHLBB staff resources and allowing more attention to be focused on problem

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institutions. In the case of both Levels 3, 4 and 5, the examinations would be comprehensive and aimed at ascertaining compliance with, and progress toward accomplishing the goals set forth in the business plan.

III. Accounting issues related to net worth.

The Task Force recommends that FHLBB regulatory accounting principles continue to be used in the proposed FHLBB net worth and examination schedules. The use of regulatory accounting principles is appropriate in setting regulatory requirements. Publicly-traded institutions will, of course, be subject to GAAP in published financial statements.

IV. Handling of insolvent institutions.

The Task Force recommends: (1) the establishment of special purpose corporations in each Federal Home Loan Bank District for the purpose of handling insolvent FSLIC-insured institutions; and (2) a time schedule of events and actions which should be followed in dealing with institutions approaching insolvency. The general objective is to reduce costs to FSLIC by establishing a new mechanism for the disposition of problem cases as well as for the earlier resolution of these cases.

These corporations would be chartered, if needed, in each Home Loan Bank District pursuant to the authority now contained in Section 406 of the National Housing Act. Their directors would be appointed by the District Bank in that District, and would, in turn, appoint the management of the companies. The directors and managers would be covered by FSLIC indemnification agreements as under the current management consignment program. The function of these corporations would essentially be to manage the orderly least-cost disposition of the assets and liabilities of FSLIC-insured institutions for which no merger partners or acquirers can be found, which have been declared insolvent and which have gone into receivership.

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The operating strategies would depend on the circumstances. The emphasis, however, would be to: (a) convert portfolio assets including real estate into cash (new lending would be prohibited except for the purpose of recovery of specific existing assets); (b) replace high-cost deposits with lower-cost funds; and (c) sell branch systems and other assets.

The corporations would be financed through the Home Loan Banks (including FSLIC-guaranteed borrowings) at the lowest cost (i.e. non-penalty rates) and with market borrowings guaranteed by the District Banks and/or FSLIC. In the current climate, the cost of such funds would be lower than that of deposits.

Before an institution is put in the hands of the special purpose corporation, every effort to find a merger partner or acquirer should be conducted. A time schedule, such as the following, would be imposed in order to facilitate the search for acquirers as well as to ensure earlier resolution of problem cases while some value remains in the institution. If an institution is determined by FSLIC to be 24 months from insolvency, it would be instructed to seek out a merger partner. If an institution is 12 months from insolvency, FSLIC would have 90 days to find a merger partner. If no merger partner can be found, the institution would be declared insolvent, go into receivership and be acquired by this new corporation.

Such a time schedule would facilitate action by the regulators on a timely basis, and help to conserve FSLIC resources. It would also provide strong incentives for institutions to improve their operations or voluntarily seek merger partners. For example, an institution which is put originally on the "24-month list" would be removed from that list if its condition improved sufficiently. On the other hand, if the institution deteriorates suddenly, this time frame would have to be accelerated.

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While there are a number of details to be filled in, I believe that the foregoing represents a balanced, well-reasoned and comprehensive approach to strengthening the FSLIC. It emphasizes private sector involvement and can be implemented immediately, without the need for additional legislative action. When combined with the improved interest rate environment in which all thrift institutions are now operating, it seems clear to us that FSLIC and the industry have sufficient reserves and future income prospects to solve their own problems.

Most importantly from the standpoint of the industry, we respectfully submit that prompt action on these recommendations will permit thrift industry problems to be resolved without the need for other counterproductive steps such as:

- Continuing the FSLIC special assessment which is costing the industry $250 million per quarter;
- Recapitalizing FSLIC via a major infusion of funds from insured institutions on either a debt or equity basis;
- Authorizing the FHLBB to override state-granted banking powers which have been a source of considerable innovation and progress for the thrift industry;
- Expanding the supervisory and enforcement authority of the FSLIC over insured institutions;
- Enacting a "thrift test" that would only serve to limit the asset flexibility so necessary to the continued recovery of both savings banks and savings and loan associations; and
- Merging FSLIC into FDIC which would threaten the long-term viability of the separate regulatory system for savings and loans and federal savings banks.

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CONCLUSION

Mr. Chairman and Members of the Committee, it is obvious that the proper functioning of the federal deposit insurance system is essential to the continued well-being of depository institutions, the customers which they serve and the economy in general. Likewise, there can be little doubt that both the FDIC and FSLIC are facing unprecedented strains on their resources due in part to the fact that the administration of both funds has failed to stay fully abreast of financial deregulation of the last several years. However, the National Council of Savings Institutions categorically rejects those legislative and regulatory solutions that would close this gap by slowing down or reversing the deregulation that has occurred to date.

The specific suggestions we have put forth today in the FSLIC area are designed to help assure continued public confidence in the nation's thrift institutions, while preserving the opportunity for well-managed institutions to grow and prosper in the years ahead. As our Task Force on Alternatives to Reregulation completes additional work, we will be glad to furnish you with its results.

I would be pleased to answer any questions which the Committee Members may have.

APPENDIX A-1

Ratio of General Reserve Accounts
to Assets of Savings Banks
1975-1985

Year	Percent
1975	6.96%
1976	6.71
1977	6.77
1978	6.90
1979	7.05
1980	6.63
1981	5.68
1982	5.30
1983	5.36
1984	5.12
1985p	5.30

p = preliminary, based on June 1985 data

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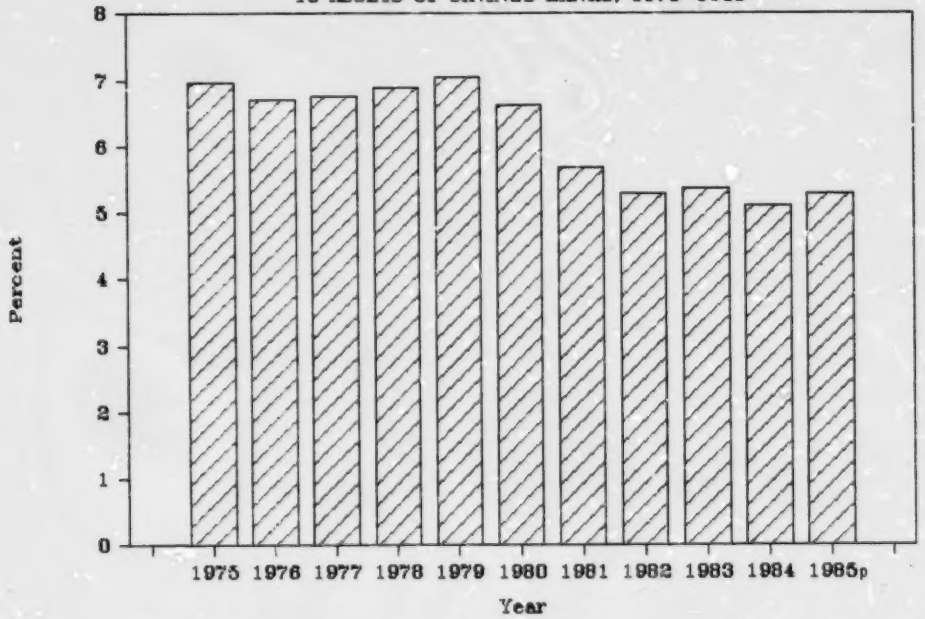
Ratio of General Reserve Accounts

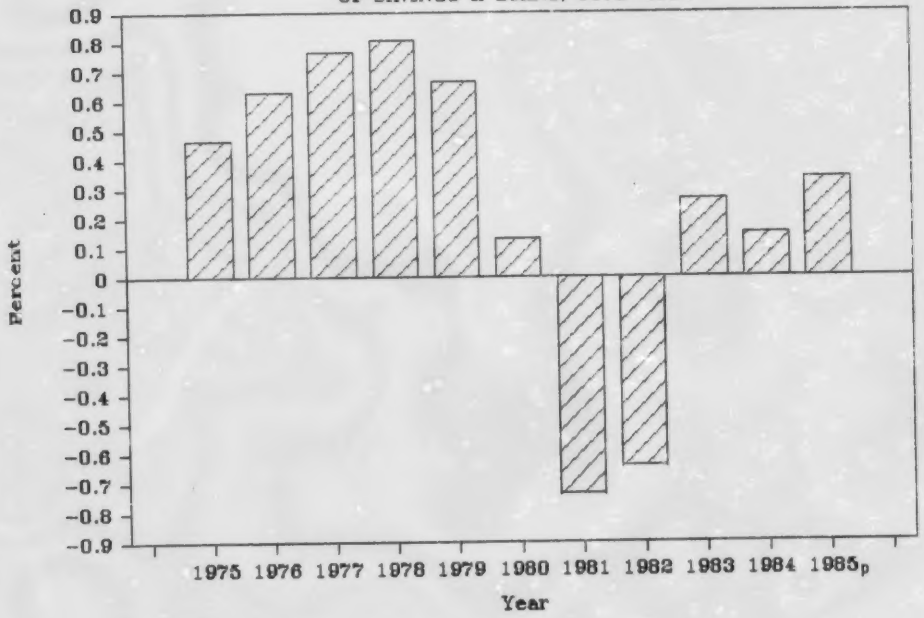
TO ASSETS OF SAVINGS BANKS, 1975-1985



p = preliminary, based on June 1985 data

Retained Earnings as % of Total Assets

OF SAVINGS & LOANS, 1975–1985



p = preliminary, based on June 1985 data.

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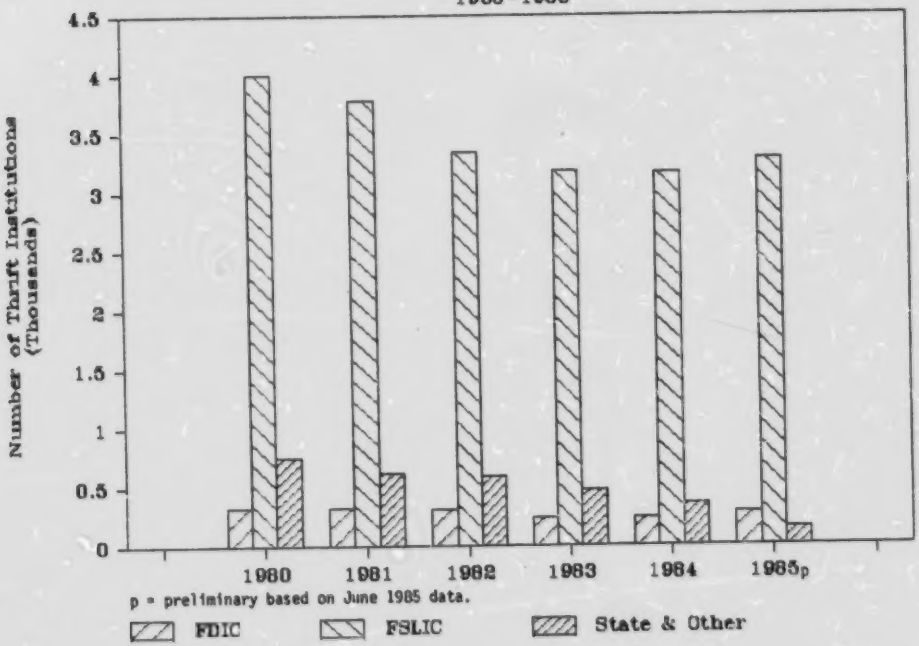
Membership in Deposit Insurance Funds,

1980-1985



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The CHAIRMAN. Mr. Levy.

STATEMENT OF GERALD LEVY, VICE CHAIRMAN, U.S. LEAGUE OF SAVINGS INSTITUTIONS; PRESIDENT, GUARANTY SAVINGS, MILWAUKEE, WI

Mr. LEVY. Thank you.

Senator PROXMIRE. Mr. Chairman, before Mr. Levy begins, just let me say that I'm delighted that Mr. Levy is here. He is a real star in Wisconsin. He's very highly respected. We know how articulate and intelligent he is and I'm delighted and honored that he's one of our witnesses this morning.

Mr. LEVY. Thank you for the kind comments.

Mr. Chairman and members of the committee, my name is Gerald Levy and I'm the president of Guaranty Savings & Loan Association in Milwaukee, WI. I welcome the opportunity to appear today on behalf of the U.S. League of Savings Institutions of which I'm currently vice chairman.

At the outset, Mr. Chairman, let me commend you for holding these very timely hearings. Congressional focus on the supervisory and examination processes, including the deposit insurance system, is definitely needed in light of the unusual stresses to which the FSLIC and FDIC are being subjected as a consequence of the financial pressures that many of the institutions they insure are encountering.

The U.S. League over the past 2 years has devoted a great deal of time toward attempting to develop recommendations in the areas under review today. The results of our efforts are spelled out in detail in our written statement and its appendices.

MERGER IS UNJUSTIFIED

What I would like to do in my oral remarks is focus on several key points of particular importance to our business. Above all, let me stress our conviction that a merger of the FSLIC with the FDIC would in no sense represent an appropriate response to the situation.

First, it would be unjustified financially. Looking at the strength of the FSLIC, although its insurance fund shrank somewhat in 1984, its reserves currently are $5.3 billion and remain far above the crisis level.

Also, with income running at an annual level of $2.3 billion, including the special assessments that Mr. Albers referred to, the agency has a strong cash flow.

Moreover, although asset-based problems have emerged as a major source of concern, the central economic problem for our business is our low-yield, fixed-rate mortgage loans which, fortunately, are sound credits. And I underscore that. The question there is receipt of less interest but no question about the repayment of the principal on those loans.

By contrast, the FDIC, notwithstanding its substantial reserves, faces a universe of problems that is almost entirely asset-based, and thus inherently more volatile than that confronted by the FSLIC.

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Among those problems are weaknesses stemming from the decline in oil prices, the farm debt situation, and badly underwritten foreign loans.

As of May 1985, the FDIC reported a problem list totaling 949 banks, up more than 100 from the close of 1984, and, at current rates, it appears that roughly 100 commercial banks, a record, will fail in 1985.

We point this out not to minimize the admittedly serious difficulties of our business, but to suggest that, given the grave problems confronting the FDIC, that agency is in no better position to deal with our dilemma than is the Federal Home Loan Bank Board and the FSLIC organization.

As a second matter, we are convinced that having a single system that unites the chartering, insuring, and liquidity-providing functions has provided us with an excellent, creative, highly coordinated system of regulation and supervision that has functioned very capably throughout a period of extreme stress. And I refer to the comments by Senator Proxmire concerning the FDIC's ability to go in and initiate examinations. That could not happen under our system where you have a combination of the Bank Board and the FSLIC.

The system consistently has been marked by a commendable willingness to take prompt, bold action, as evidenced by the direct investment regulation, growth restrictions, AD&C—acquisition, development and construction—loan limitations, and other initiatives when necessary to protect savings institutions and their depositors.

It would be a terrible mistake to disassemble this structure by dismantling the FSLIC, a course which was rejected by the Vice President's report of the Task Force on Regulation of Financial Services, despite careful and detailed examination of the subject.

Finally, consolidation would mean that a substantial segment of the industry, those institutions with State charters, no longer would have a primary Federal regulator that was institutionally sensitive to the importance of thrift institutions' specialized home finance mission.

We believe the ultimate result of a merger would be to unravel the entire Federal regulatory structure designed to assure the continued existence of depository institutions committed to the provision of mortgage credit. This would be a victory for those who, believing public policy has been too supportive of housing, have long worked toward depository homogenization; but it would represent a dramatic setback for the millions of Americans who aspire to the dream of homeownership. To reiterate, the U.S. League will oppose very vigorously any attempt to merge the FDIC with the FSLIC.

As I noted at the beginning of this statement, the U.S. League is convinced that the problems facing the FSLIC, while serious, are manageable. Moreover, it is our belief that they can be resolved without drawing upon resources—whether those of the American taxpayer or the FDIC—from outside our system.

We still have great resources at our command and, of equal significance, the will to use them. One of the primary resources is the Federal Home Loan Bank System. The 12 district Federal Home Loan Banks operate what amounts to a central banking system for the savings institution industry. Furthermore, under our regula-

tory system, the banks are deeply and directly involved in the supervisory process. This cohesive, centralized approach offers a striking contrast to the troubled Farm Credit System which appears to suffer from an excess of autonomy among its component parts.

Financially, the Federal Home Loan Banks are very strong, with net worth of approximately $9 billion. This results from a conservative management style, particularly with regard to the payment of dividends. This conservatism is perhaps epitomized by the Federal Home Loan Banks' rigorous approach to collateralization of advances with sound assets; again, in apparent contrast to the practices of some lenders within the Farm Credit System.

CREATION OF A SPECIAL ASSET MANAGEMENT CORPORATION

While the financial strength the banks have built up over the years has already proved useful to the FSLIC through advances to members and direct loans to the FSLIC, a new technique—creation of a special asset management subsidiary—promises to leverage that usefulness substantially.

I might clarify at this point that we do not envision 12 separate corporations, but rather a single corporation. And I might go further, that that is not the only difference between the proposal from the National Council and our proposal. The National Council proposal also would seem to call for a combining of the assets and liabilities of the troubled institutions. We would call for a taking over of the assets. Once the bad assets were off the statement, you would have an institution, with its liability structure and its remaining assets, that would be a salable commodity probably at a premium.

This subsidiary would be a special private sector corporation—and I repeat that—private sector corporation jointly owned and capitalized by the FSLIC and the Federal Home Loan Banks that would obtain receivership assets from the FSLIC and employ a staff of experts to manage and dispose of those assets on the most favorable basis.

The FSLIC would be given a mix of stock and notes for the assets and a subsidiary would pay off the notes by borrowing in the open market, thus providing the FSLIC with a welcome cash infusion which would increase their unobligated balance.

Use of an asset management subsidiary would significantly benefit the FSLIC and our business by permitting the most profitable disposition of FSLIC assets and by serving as a vehicle for use by the FSLIC, in effect, of some of the capital of the Federal Home Loan Bank System.

Turning to the issue of risk-based insurance, the U.S. League, as we testified before this committee in June, remains skeptical with respect to the practicality of this approach. We are, however, willing to endorse a 2-year, limited scope, variable premium program to enable Congress to obtain some hard information in this area.

From the standpoint of our industry, a more important and ultimately a more beneficial step would be to free the Federal Home Loan Bank Board/FSLIC organization from the various legal constraints that prevent it from hiring, firing, and compensating its

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personnel on a competitive businesslike basis. I must depart and say that if one looks at the structure of the FSLIC and the FDIC, the FDIC has some 3,500 employees. The FSLIC has just over 100. In the liquidation areas, the FDIC has almost 1,500 people. The FSLIC has about 23 or 24. It's clear that they have a personnel problem. I would point out that freeing up the FSLIC and the Federal Home Loan Bank Board to expand their staff would not be at the expense or the cost of the taxpayer. The cost would be borne by the savings and loans.

The draft bill we have submitted with our written statement would accomplish this objective and we hope you will give your close consideration.

Other related and important steps would include providing the Bank Board with enhanced enforcement tools, developing a more focused, expert-intensive approach to dealing with supervisory problems and relying more heavily on industry expertise in the management of financially troubled institutions.

Finally, the U.S. League continues to advocate a 3-year extension of the Net Worth Certificate Act and the title I emergency provisions of the Garn-St Germain Act.

Mr. Chairman, this concludes my remarks and I will be happy to answer any questions. Thank you.

[The complete prepared statement follows:]

STATEMENT

OF THE

U. S. LEAGUE OF SAVINGS INSTITUTIONS

PRESENTED BY

GERALD J. LEVY, PRESIDENT

Mr. Chairman, members of the Committee, my name is Gerald J. Levy and I am president of Guaranty Savings and Loan Association, a savings institution located in Milwaukee, Wisconsin. I welcome this opportunity to appear before you today on behalf of the U. S. League of Savings Institutions*, of which I currently am Vice Chairman.

At the outset, Mr. Chairman, let me commend you for holding these very timely hearings to review the supervisory and examination processes, including the deposit insurance system, affecting depository institutions. Congressional focus on these areas definitely is needed in light of the unusual stresses to which the Federal Savings and Loan Insurance Corporation and the Federal Deposit Insurance Corporation are being subjected as a consequence of the financial pressures that many of the institutions they insure are encountering. These pressures have resulted from a variety of factors -- ranging, for example, from overly hasty deregulation of deposit interest rates, to government policies that resulted

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*The U. S. League of Savings Institutions, serves more than 3,500 member institutions which make up the $1.1 trillion savings association and savings bank businesses. League membership includes all types of institutions -- federal and state-chartered, stock and mutual. The principal officers include: John B. Zellars, Chairman, Atlanta, Georgia; Gerald J. Levy, Vice Chairman, Milwaukee, Wisconsin; Willian B. O Connell, President, Chicago, Illinois; Philip Gasteyer, Executive Vice President and Director of Washington Operations; and James O. Freeman, Senior Vice President and Senior Legislative Representative. League headquarters are at 111 East Wacker Drive, Chicago, Illinois 60601. The Washington Office is located at 1709 New York Avenue, N.W., Washington, D.C. 20006. Telephone: (202) 637-8900.

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in savings institutions having portfolios full of low-yield, fixed-rate mortgages, to foreign loans made with inadequate underwriting, to serious weakness in the farm and energy sectors -- but have had the uniform effect of creating enormous supervisory challenges.

Because changes clearly are needed, the U.S. League over the past two years has devoted a great deal of time to attempting to develop recommendations for improvements regarding the examination and supervisory processes, including the deposit insurance system. The bulk of my testimony will be devoted to detailing the results of our efforts.

To highlight our positions very briefly, let me stress, first, our conviction that a merger of the FSLIC with the FDIC would in no sense represent an appropriate response to the situation. Financially, it would be unjustified, and, from a regulatory standpoint, it would fragment the current efficient and unified system of thrift regulation. We believe it would lead ultimately to a dissolution of the entire federal regulatory structure aimed at encouraging specialized housing lending. The U.S. League must oppose in the strongest terms any initiative designed to bring about a consolidation of the deposit insurance agencies.

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While the problems the FSLIC is confronting are serious, we are fully convinced that they are manageable and can be resolved without drawing upon resources from outside our system -- whether those of the taxpayers or the FDIC. One of the best means of accomplishing this could be through implementation of a new concept -- the asset management subsidiary. This would be a special, private-sector corporation, jointly owned and capitalized by the FSLIC and the Federal Home Loan Banks, that would obtain receivership assets from the FSLIC (on terms beneficial to the latter) and employ experts to manage and dispose of those assets on the most favorable basis. Use of the asset management subsidiary would benefit significantly the FSLIC -- and our business -- by permitting the most profitable disposition of the assets the FSLIC has obtained through its receivership function, and by serving as a vehicle for use by the FSLIC, in effect, of some of the capital of the FHLBank System.

Turning to the issue of risk-based insurance, the U.S. League remains skeptical with respect to the practicality of this approach. We are, however, willing to endorse a two-year, limited-scope variable premium program to enable Congress to obtain some hard information in this area.

From the standpoint of our industry, a more important and ultimately more beneficial step would be to free the

FHLBB/FSLIC organization from the various legal constraints that prevent it from hiring, firing and compensating its personnel on a competitive, businesslike basis. This would assure it of the ability to attract and retain a staff of the size and talent necessary to provide our industry with the highly qualified supervision so critically important in today's continuously evolving financial environment, as well as to assure the most efficient use of the FSLIC insurance fund.

Other related and important steps would include providing the Bank Board with enhanced enforcement tools, particularly in the temporary cease-and-desist order area, developing a more focused, expert-intensive approach to dealing with supervisory problems, and relying more heavily on industry expertise in the management of financially troubled institutions. And, as you are aware, the U.S. League continues to advocate an extension of the Net Worth Certificate Act as a means of preserving for the FHLBB a valuable tool for avoiding insolvencies of well-run institutions that are victims of the fixed-rate, low-yield mortgage trap and that are restructuring.

U.S. League Opposes Merger of FSLIC with FDIC

The first point I would like to cover is the possibility of a merger of the FSLIC and FDIC. Such a merger has been

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under considerable discussion in financial circles this year, a fact attributable to, among other factors, the pro-consolidation statements of FDIC Chairman Isaac.

As we testified in June, the U.S. League would oppose strenuously any attempt to remove the FSLIC from Bank Board jurisdiction and consolidate that insurer with the FDIC. We continue to be convinced that such an action would be unjustified, not just from the standpoint of the relative financial problems of the FSLIC and FDIC, but in that it would diminish the effectiveness of thrift regulation, and tend to erode our ability to maintain a system of specialized housing lenders.

Concerning the strength of the FSLIC, we note that, although its insurance fund diminished in size somewhat in 1984, its reserves, currently $5.3 billion, remain far above the crisis level, and that the agency, with income running at an annual level of $2.3 billion (including special assessments), has a strong cash flow. Moreover, although asset-based problems have emerged as a major source of concern for the FSLIC, the central economic problem for our business remains the interest-rate-based problem of our huge collective portfolio of underwater, fixed-rate mortgage loans. Fortunately, these investments (which, although low-yield, are

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sound credits) are getting to the point where significant numbers of them are beginning to roll over into market rate assets.

By contrast, the FDIC, notwithstanding its substantial reserves, faces a universe of problems that is almost entirely asset-based, and thus inherently more volatile than that confronted by the Bank Board. These problems include, most particularly, weaknesses stemming from the decline in oil prices, the farm debt situation (according to the U.S. Department of Agriculture, of the $212 billion in outstanding farm debt at the end of 1984, some 15% -- about $32 billion -- was held by insolvent farm operations), and badly underwritten foreign loans. We note that taking loan loss reserves into account, 38 -- or 14% -- of the 276 commercial banks with $1 billion or more in assets had a nonperforming loans (plus REO) to equity (plus reserves) ratio of 50% or more. Moreover, these figures generally do not include dubious loans to countries such as Argentina; banking regulators, ever quick to snipe at "funny accounting" in the thrift industry, do not even classify them as "substandard." In any event, as of May 1985, the FDIC reported that its problem list amounted to a total of 949 banks -- an increase of more than 100 from the close of 1984 -- and at current rates it appears that roughly 100 commercial banks -- a record -- will fail in 1985.

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We point this out, not to minimize the problems of the savings institution industry, the magnitude of which the U.S. League is all too familiar with, but to suggest that, given the serious problems confronting the FDIC, that agency, as a practical matter, hardly can be regarded as being in a better position to attempt to deal with the problems of the savings institutions industry than is the Bank Board/FSLIC organization. Moreover, we question whether the FDIC's experience as a commercial bank liquidator has equipped it with substantial expertise in real estate, the area of most vital concern to the FSLIC. Successfully working out troubled real estate projects requires great skill and experience, and we suspect we would be trading down in this area were the FSLIC to disappear into the FDIC.

Looking at the question of effective regulation of thrift institutions, we are convinced that having a single system that unites the chartering, insuring and liquidity-providing functions has provided us with an excellent, creative, highly-coordinated system of regulation and supervision that has functioned very, very capably throughout a period of extreme stress. It would be a terrible mistake to disassemble this structure by dismantling the FSLIC -- a course which, we note, was rejected by the Vice President's Report of the Task Force in Regulation of Financial Services, despite careful and detailed examination of the subject.

Not only would consolidation be an error from the standpoint of regulation and supervision, it would mean that a substantial segment of the industry -- those institutions with state charters -- no longer would have a primary federal regulator that was institutionally sensitive to the importance of thrift institution's specialized home finance mission. We are convinced that the ultimate result of a merger of the insurance funds would be an unravelling of the rest of the special federal regulatory structure designed to assure the continued existence of depository institutions committed to the provision of mortgage credit. This would be a victory for those who, believing public policy has been too supportive of housing, long have worked towards depository homogenization; but it would represent a dramatic setback for the millions of Americans who aspire to the dream of homeownership. To reiterate, the U.S. League will oppose very vigorously any attempt to merge the FDIC with the FSLIC.

U.S. League Supports Creation of Special Asset Management Subsidiary

As I noted at the beginning of this statement, the U.S. League is convinced that the problems facing the FSLIC, while serious, are manageable. Moreover, it is our belief that they can be resolved without drawing upon resources -- whether those

of the American taxpayer or the FDIC -- from outside our system. While our industry and its principal insurer have been battered by the events of the past few years, particularly the disastrously inappropriate pace of deposit deregulation, we still have great resources at our command and, of equal significance, the will to use them.

One of the primary resources is the Federal Home Loan Bank system, which consists of the twelve district Federal Home Loan Banks. Authorized in 1932 by the Federal Home Loan Bank Act, the banks operate what amounts to a central banking system for the savings institution industry, serving as a major source of our liquidity. Furthermore, under our regulatory system -- which, under overall Federal Home Loan Bank Board control, ties together in an extremely coordinated and effective manner the chartering insuring and liquidity-providing functions -- the banks are deeply and directly involved in the supervisory process. Each bank president is the Principal Supervisory Agent for his district, and, in addition, the banks recently have been delegated responsibility for operating the examination function. We note that this cohesive, centralized approach offers a striking contrast to the troubled Farm Credit system, which appears to suffer from an excess of autonomy among its component parts.

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Financially, the FHLBanks are very strong, with net worth of approximately $9 billion and reserves in excess of paid in capital of $1.7 billion. This is the fruit of a management style that over the years has been quite conservative, particularly with regard to the payment of dividends to the member savings institutions that are its stockholders. I should note that this conservatism is perhaps epitomized by the FHLBanks' rigorous approach to collateralization of advances with sound assets; again, in apparent contrast to the practices of some lenders within the Farm Credit System.

While the financial strength the banks have built up over the years already has proved useful to the FSLIC through advances to financially troubled members and direct loans to the FSLIC, a new technique, creation of a special asset management subsidiary, promises to leverage that usefulness substantially. In addition to providing a means for the transfer, in effect, of some of the FHLBanks' capital to the FSLIC, the subsidiary should make it possible for the FSLIC to realize a much better return on the assets it acquires in connection with its default-prevention work.

The asset management subsidiary would be a federally chartered, private sector corporation created under authority of section 406 of the National Housing Act. Its purpose would be to manage and ultimately sell for the best possible price

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troubled assets the FSLIC acquires pursuant to its receivership and related functions. Initially, the corporation would be formed as a wholly-owned FSLIC subsidiary, to which FSLIC would contribute assets -- mostly buildings and other real estate -- having a book value of approximately $3 billion. In return the FSLIC would receive $500 million in stock, and notes in the amount for the balance. (It should be noted that this transaction would enable the FSLIC to clear its balance sheet of items that have been carried under accounting and budgetary rules that tend to underestimate the financial condition of the insurance fund.) Thereupon the FHLBanks would purchase enough stock to provide the corporation with an extra $300 million in cash, bringing paid-in capital to a total of $800 million. The subsidiary then would be in a position to tap the capital markets for additional funds that it could use to pay off its notes from the FSLIC -- thus providing the latter with a welcome cash infusion -- and for other purposes. It is envisioned that the FHLBanks would provide sufficient additional capital over time to assume voting control of the subsidiary.

As a private corporation, the asset management subsidiary would not be bound by federal agency restrictions on hiring, firing and compensation, and accordingly would be able to attract and retain management and staff that were truly expert in the business skills needed to assure that the corporation's

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assets were disposed of ultimately at the best possible price. The ability to operate as a private sector entity is, we are convinced, absolutely central to the successful accomplishment of the corporation's goals. Maximizing the return on the assets of the corporation will require expertise of a kind that is developed and perfected in a business, as opposed to a governmental, environment. Simply put, the best way to bring a high return from these assets in the free market is to have a strong, highly motivated company with a creative chief executive and a group of aggressive employees experienced in real estate marketing.

From a legal standpoint, it appears that adequate authority exists to implement the program now. Under 12 U.S.C. 1437(a), as amended by the Garn-St Germain Act, any function of the FSLIC -- in this case managing and disposing of assets -- can be delegated to the FHLBanks, which arguably would appear to provide a basis for the latters' financial participation in the subsidiary, apart from authority derived from their statutory grant of incidental and general corporate powers. It would be desirable, however, to clarify this point through legislation. It also would be appropriate to amend the FHLBank Act to assure that the banks' investment in the corporation does not unnecessarily affect their ability to provide their stockholders with dividends.

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U.S. League Supports Limited, Experimental Variable Risk Premium Program

For the past several years, there has been a great deal of discussion of the issue of risk-based federal deposit insurance. Support for such insurance has been voiced both by the FDIC and the Bank Board, although the latter agency has not embraced the FDIC's across-the-board approach, seeking instead to assess additional premiums only against institutions engaging in activities of a nature or to an extent not permitted for federal associations.

The variable premium question, of course, is one of great interest and importance to our members, and the League has devoted considerable time and effort to reviewing this issue. Our basic conclusion, as we testified before this Committee in June, is that, while the League recognizes the substantial theoretical appeal of the concept, we continue to have doubts as to whether the requisite regulatory engineering can be developed to convert this concept into a fairly and effectively functioning reality. Clearly, many very complicated issues of implementation remain regardless of the approach to variable premiums one favors. It will be very difficult to answer, for instance, such questions as: What is risky? How risky is it? Who makes the determination of riskiness? What criteria are used in making these determinations? How much more must be

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charged to defray the risk? Should premiums be related to riskiness of specific individual investments or to general categories of investments?

Consistent with our June testimony, the League continues to be unwilling to support a full-scale, open-ended authorization of variable premiums, but remains willing to support a limited, experimental program that would apply supplemental premiums to real estate development and non-financial activities, and which would be subject to a two-year sunset provision. We believe the sunset is particularly appropriate in light of the reduction of the exposure of the FSLIC fund that should be accomplished by various Bank Board regulatory initiatives, including the direct investment rule and new accounting restrictions on acquisition, development and construction loans.

In the League's view, the experimental premium framework should be coordinated with a system of variable net worth standards that would apply to the same activities covered by risk-based insurance. With respect to developing the actual structure governing how much, in terms of premiums and additional net worth, risky activities would entail, we are convinced the Bank Board should be required to tie that structure to an analysis of what activities have caused the FSLIC the most losses.

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The virtue of using a dual premium/net worth approach is that is would allow institutions to avoid the necessity of having to expense the entire regulatory "price" imposed for engaging in riskier activities, thus reducing the extent to which earnings and capital rebuilding -- so essential to the future health of our business and the FSLIC -- otherwise would be impaired. As we envision it, the additional reserves required for risky investments would not be in the nature of permanent additions to capital, but could be redeployed with the successful disposition of the relevant investments. Such an approach, of course, would affect most heavily the investment strategies of low-net-worth institutions; organizations with surplus net worth would be rewarded with greater flexibility for, in effect, their strength.

The League believes that an experimental, integrated program of the kind we have outlined would provide the financial community with some necessary, and currently nonexistent, hard information about the functioning of risk-based insurance. Only when Congress has such information available will it in the end be able accurately to decide whether advocates of such insurance are advancing a practical solution to FDIC and FSLIC problems, or one which defies meaningful implementation.

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Need For Restructuring of FHLBB/FSLIC

Notwithstanding our support of a limited risk-based insurance experiment, it is the position of the U.S. League that a step that would be far more beneficial would be to effect changes in the legal status of the Bank Board (and its constituent FSLIC) to enable it to maximize its ability to deal with the current and emerging challenges confronting it as a regulator. We must emphasize that circumstances -- including the deregulation of interest rates, the expansion of investment and other authorities at the state and federal level and the ongoing negative impact on savings institutions of their portfolios of low-yield, fixed rate mortgages -- have brought about a fundamental qualitative as well as quantitative alteration in the tasks the Bank Board must perform to discharge its responsibilities of assuring the safety and soundness of the nation's thrift industry and ensuring that the FSLIC is able to fulfill its obligations to depositors.

In our view, it is essential that the great increase in the difficulty of the job the Bank Board must perform be accompanied by a restructuring of the agency to ensure, most particularly, that its staff resources will not prove inadequate, whether in quantity or quality. The U.S. League is convinced that the current, essentially standard federal agency status of the Bank Board -- which contrasts sharply with the

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treatment afforded the commercial bank regulators -- simply does not allow sufficient flexibility with regard to the hiring, firing and compensation of personnel to assure us that, over time, critical regulatory challenges will continue to be met.

We note that the first of the written guideline questions posed to the various witness testifying at this hearing dealt with whether our ability to assess the condition of financial institutions could be enhanced through more timely data, improved analytical techniques, additional sources of information, increased ability to predict failure and more and better personnel. Our opinion is that the personnel component is the most critical one in that listing; without engaging in the size and quality upgrading of staff that restructuring of the agency will permit, it is questionable of what effectiveness additional data and new techniques would be. In any event, it does not appear to us that the Bank Board has been deficient in terms of gathering data or keeping abreast of the best approaches for utilizing it. Again, our concern is that the information collection and analysis process be conducted by a staff of a size and skill commensurate with the volume and complexity of the facts under review.

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Accordingly, we are proposing that Congress revise the present legal framework governing the Bank Board (and the FSLIC) to enable it to function, in terms of budgeting, expenditures and personnel constraints, as a "mixed ownership government corporation," a status currently enjoyed by the Federal Deposit Insurance Corporation and the Federal Home Loan Banks. To that end, we have attached for your consideration a draft bill entitled the Savings Institutions Regulatory Improvements Act (Appendix A), together with a section-by-section analysis (Appendix B).

As our draft bill is framed, it would free the Bank Board from Office of Management and Budget budgetary oversight and review, Appropriations Committee jurisdiction, and federal personnel restrictions (except those pertaining to employers generally). It also would clarify that the Bank Board, like the FDIC, is not required to submit to OMB "apportionment" requirements, under which future expenditures must be estimated or "apportioned" on a quarterly basis, with expenditures above estimated amounts subject to OMB approval. No change would be made in the manner in which Bank Board members are appointed, however, and the General Accounting Office would continue to have audit authority over the agency, although the FSLIC would be treated like the FDIC and no longer would be subject to a mandatory annual audit requirement.

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The U.S. League realizes, of course, that the Congress already has provided the Bank Board with an important agency restructuring tool in the form of the "delegation" amendment made to 12 U.S.C. 1437(a) by the Garn-St Germain Act. Indeed, the Bank Board recently utilized this authority to delegate, in effect, its examination function to the FHLBanks -- a step which we have applauded. While we support the widest possible use of section 1437(a) authority, we believe, however, that a straightforward revision of agency status along the lines contained in our draft bill is the most desirable route.

As our final point, we wish to emphasize that the increased costs that would accompany the restructuring we are urging would be borne by the savings institution industry rather than by the taxpayers, for the Bank Board and the FSLIC derive their funds not from taxes, but from FHLBank assessments, examination fees, insurance premiums, and interest earned on the FSLIC fund. This additional expense is one we would incur gladly, however, for we believe its cost-effectiveness, in terms of assuring top-quality regulation, would be very high. The positive effects associated with such regulation -- ranging from minimizing the pressures on, and maximizing the effective use of, the FSLIC fund, to facilitating prompt and efficient processing of applications -- cannot easily be quantified in dollar terms, but clearly would be of very great financial benefit to our business.

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Mr. Chairman, the U.S. League regards our proposed Savings Institutions Regulatory Improvements Act as a measure of great significance for our business and has assigned it a very high legislative priority. We realize the Congressional tendency in recent years has been to be skeptical of requests of this kind, and would not be advancing such a proposal without the strongest sense of its importance. It is our hope that you will give our draft your most careful consideration.

New Enforcement Powers Necessary for Bank Board

As the Committee is aware, the Bank Board is extremely interested in upgrading its arsenal of enforcement tools in order to enable it to deal more quickly and effectively with the "high-flier" institutions that pose such a threat to the FSLIC. The U.S. League shares the agency's concern regarding the negative effects on the FSLIC of reckless or dishonest operators, and we have examined with great care the new powers the Bank Board is seeking, as contained in S. 759, the Insured Institutions Improvements Act. Although we by no means endorse all the changes the Bank Board is urging, we have concluded, as we testified before this Committee in June, that we can support important statutory changes in this area, particularly with regard to expanding the agency's authority regarding temporary cease-and-desist orders. Because our detailed views on the specifics of the Bank Board's proposal remain the same as those

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expressed in our June testimony, we have excerpted the relevant portion therefrom and included it as Appendix C, rather than duplicating our position in the main body of this statement. Please bear in mind that our support for new power is contingent upon the various modifications to the Bank Board's proposal that we describe in Appendix C; we are convinced they represent a reasonable reconciliation of the competing supervisory, due process, and public confidence issues involved.

With regard to enforcement powers generally, one of the questions posed in your invitation to testify concerned what types of policy guidelines should exist for each type of enforcement action. Lacking access to the Bank Board's enforcement files, it is not really possible to respond with particularity on this issue; we simply do not have an accurate sense of the behavorial continuum with which the agency is confronted. Our general sense, however, is that the Bank Board, especially in recent years, has exercised its prosecutorial discretion in an intelligent manner, choosing remedies that are appropriate to institutions' conduct. Moreover, our impression is that there is much greater cooperation, integration of effort, and consensus on approach among examiners, supervisory agents and enforcement attorneys than was the case several years ago. This appears to have contributed to an improvement in the cost-effectiveness of the allocation of enforcement resources and a trend toward more rapid resolution of cases.

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The U.S. League hopes these gains will be strengthened and prove permanent. Past complaints about the Bank Board's enforcement policies generally revolved around the perception, first, that in too many instances relatively trivial cases would be pursued vigorously with the object of obtaining a formal order, while major problems too often were dealt with informally and with excessive indulgence, and, second, that an excessive amount of time would elapse from the time a violation was uncovered until a decision to pursue formal enforcement action was made, and, thereafter, until an order finally was issued.

U.S. League Supports Revised FHLBB Approach to Supervision

While the U.S. League has supported many of the FSLIC-protective regulatory initiatives that the Bank Board has implemented over the past two years, including the direct investment regulations, we continue to prefer to see problems resolved on other than a broad-bush, lowest-common-denominator basis. The prospect of new enforcement tools and enhanced staff resources raises, in our view, the possibility that at some point the agency may be able to retreat from reregulation and deal more effectively with supervisory issues on a case-by-case basis.

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With this in mind, we have suggested to the Bank Board, as we testified in June, that it begin focusing intense supervisory efforts on the activities of the kinds of high flier institutions that pose the greatest potential threat to the FSLIC. New powers and the lifting of personnel constraints would allow this approach to reach optimum effectiveness, but we believe, considering the delegation of the examination function to the FHLBanks, that the Bank Board could commence implementation now. The ultimate objective would be the development and use of highly qualified teams of examiners, lawyers and financial experts that would be able to come to grips with complicated problems with maximum speed and skill. Let me emphasize that we in no way envision this program as lessening the agency's overall supervisory efforts regarding other institutions.

Disclosure and Supervision

One purported approach to enhancing supervision that we are not urging upon the Bank Board is routine disclosure of the existence of administrative enforcement orders, an approach adopted by the FDIC and the Office of the Comptroller of the Currency. The difficulties of privately insured thrifts in Ohio and Maryland should serve as a stark reminder of the great vulnerability of financial institutions to the efforts of bad publicity. We believe it is highly irresponsible for the FDIC

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and OCC to foster a situation that invites bad publicity, not just for the institution involved in the enforcement action, but for others as well.

In terms of whether the threat of publicity will make institutions more willing to follow regulatory direction, we firmly agree with the traditional bank Board view that a general policy of confidentiality enhances enforcement efforts by making targets more willing to comply with orders without litigation. While it is possible that the FDIC/OCC approach might facilitate informal resolution of some individual disputes, we note that this result could be achieved without a blanket disclosure policy simply by selective targeting in appropriate cases. But as a general matter, we seriously question the desirability of a policy that would encourage informal resolution of serious cases, thus sacrificing the important procedural and other advantages flowing from issuance of a formal order.

We also question the impact of such a disclosure policy on the examination process, which essentially is conducted with the expectation of confidentiality. Institutions which realize they have a potential supervisory problem that ultimately could lead to a publicized formal order inevitably will be less forthcoming with examiners than they would under a regime where confidentiality was preserved. Information could not be

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developed as rapidly, slowing down the examination process and thus interfering with the Bank Board's ability to detect and respond to violations of unsafe or unsound practices at an early date.

Management Sharing Program

In our June testimony, we reviewed for the Committee the U.S. League's Management Sharing Program, which we continue to believe represents an excellent supervisory cost-reduction tool that could be used to relieve some of the pressure on the FSLIC insurance fund and could reduce as well the strain on the agency's staff. This would be accomplished through the routine employment of industry resources to manage problem physical assets and problem institutions.

With respect to assuring the best resolution of cases involving problem physical assets, the program would focus on establishing a structure under which the FSLIC could identify and retain experts from inside or outside the savings institution industry who would manage those assets. This would involve creation by the FHLBanks of Regional Advisory Commission (RACs) for this purpose; at least one would be located in each FHLBank district. Each RAC would consist of the Principal Supervisory Agent (PSA), a local FSLIC representative, the state supervisor (where state-chartered

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institutions were involved), and representatives of local savings institutions. Industry representatives would be appointed by the PSA and would receive some form of compensation, and RACs would have support staff who would be paid by the relevant FHLBank. Recommendations of RACs, if accepted by the PSA, would be approved automatically under delegated authority if the amount of funds involved were less than a specific figure.

In terms of dealing with problem institutions, we have recommended that the FSLIC rely routinely on a "consignment" approach whereby management expertise in effect would be hired from other savings institutions or, if necessary, commercial banks. The choice of a management agent would be the responsibility of the PSA and would be made on the basis of the (a) willingness of management agents to place any capital at risk in the arrangement; (b) management agent's capacity and track record; (c) business plan submitted by each applicant; and (d) structure of management agent compensation, including management fee, right of first refusal in subsequent mergers, transferability of such right, option on assets, branch system, and so forth.

Because of the exposure to the FSLIC caused by high-risk operating strategies on the part of troubled institutions trying to recoup losses, institutions coming under a management

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agent arrangement would be confined in their resuscitatory efforts to prudent practices. In particular, institutions in cases where a management agent solution was contemplated would be run strictly according to a business plan. Departure from the plan would require prior PSA approval.

As you may be aware, the Bank Board has adopted a consignment approach in a number of recent cases. While we have communicated a detailed description of our proposed program to the agency, the Bank Board has not publicized the details of the arrangements into which it has entered, and we are unaware to what extent, if any, it has drawn upon our suggestions. We remain quite enthusiastic over the cost-saving potential of our program, and are hopeful that the Bank Board will embrace at least substantial portions of it.

U.S. League Supports Extension of Net Worth Certificate Act

In our June statement, we expressed our gratitude to you Mr. Chairman, for your support last year in providing in S. 2851 for an extension of the Net Worth Certificate Act and expressed the hope that you and your colleagues would continue to work with us to assure that the Act's benefits would not be lost. Those benefits flow from permitting well-managed institutions to escape unnecessary insolvencies, thus avoiding the disruptions and increased financial concentration, and,

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potentially, some of the expenses, associated with the forced merger route, as well as from enabling the FSLIC to devote more staff attention to resolution of truly serious cases involving problems of management or asset quality. The U.S. League believes a three-year extension of the Act would be appropriate.

We are aware that in some quarters the significance of the expiration of the program has been downplayed on the theory that the Bank Board could substitute use of income capital certificates (ICCs) for net worth certificates. ICCs were developed prior to the enactment of the Garn-St Germain Act as part of the agency's Phoenix program under which it provided repayable capital infusions to large insolvent institutions that it would be too expensive to liquidate.

It is true that the Bank Board would have considerable flexibility to employ ICCs under 12 U.S.C. 1729(f)(1), which allows the FSLIC to make, inter alia, loans or contributions to insured institutions (1) to prevent their default, (2) to restore them to normal operation if they are in default, or (3) to lessen the risk to the FSLIC where the agency determines that severe financial conditions exist threatening the stability of a significant number of insured institutions or of insured institutions possessing significant resources. For a variety of reasons, however, we believe that renewal of the net worth certificate program would be a far superior approach to

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assisting well-run but financial troubled institutions than would reliance upon section 1729(f)(1) authority.

First, unlike section 1729(f)(1) assistance, which must be bottomed on subjective determinations regarding the possibility of default or recovery therefrom or the existence of "severe" financial conditions, net worth certificates basically may be provided to any well-run institution with net worth of 3% or less that is suffering operating losses. Thus, net worth certificates potentially are available to a wider variety of institutions than are ICCs, and eligibility is far easier to determine.

Second, without the renewal of the net worth certificate legislation, there would be no barrier to conditioning grants of assistance to any institutions upon agreements to merge or change management. Current law governing the program specifies that such conditions may not be imposed where the FSLIC determines that the recipient institution has, with regard to mergers, more than 6 months left of positive net worth, or in the case of management changes, more than 9 months.

Third, present law specifies that net worth certificates may be counted as capital regardless of any statutory or regulatory obstacles. Similarly, the existing net worth certificate statute also overrides any state laws that would

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interfere with an institution's ability to take part in the net worth certificate program. If the legislative underpinnings of the program were permitted to lapse, many state-chartered institutions could find participation in any ICC assistance plan impractical or even illegal because of the lack of an equivalent federal override regarding section 1729(f)(1) assistance.

Fourth, to assure that federal assistance is not diverted to local or state government authorities, current law states that, while an institution has net worth certificates outstanding, it shall not be liable for any tax based on deposits held or the interest or dividends paid on those deposits. Again, lapse of the program would mean the end of this protection, thus, in effect, leading, should the FSLIC embark upon a substitute assistance plan employing ICCs, to an unjustified diversion of FSLIC funds from insured institutions to state and local governments.

Finally, without the net worth certificate legislation, the FSLIC would have no authority whatsoever to provide assistance to institutions insured by private funds. Current law allows such aid, subject to certain requirements pertaining to assessment levels and indemnification.

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Accordingly, in our view, the ICC approach would be a very imperfect substitute for the net worth certificate program. We are convinced that Congress should act to assure continued availability of NWCs, rather than rely upon the FSLIC's ability to issue ICCs.

As a final matter, you may recall that, in connection with a question posed at the June hearings, we provided a response (prepared by our Research Division) for the record that provided a detailed discussion of the general operation and usefulness of the net worth certificate program. Because of its length, we are not incorporating it into this statement, but have included it as Appendix D.

Need to Extend Emergency Authorities Contained in Title I of Garn-St Germain Act

The Net Worth Certificate Act, however, is not the only Garn-St Germain Act authority that should be extended in the interests of protecting the FSLIC and enhancing supervision. The U.S. League urges you to provide a general three-year extension for all the emergency authorities contained in Title I of the Act. They currently are scheduled to expire on October 15, 1985. The emergency acquisitions power created by section 123 is the best known of these, but the Act also provided valuable authority regarding conversions and

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receiverships that, given the distress still besetting our industry, should not be allowed to lapse.

Section 123 essentially allows the Bank Board, as a means of conserving FSLIC's resources, to authorize virtually any kind of acquisition of a savings institution -- subject to antitrust limitations. This provision has been the source of great savings for the FSLIC, and, given the likelihood that the insurance fund will remain under considerable pressure for several years as institutions financially battered by the 1981-82 crisis attempt to regain health, promise to provide such savings in the future as well.

Consistent with our testimony in June, however, we continue to oppose substantive changes in the emergency acquisitions statutes of the sort contained in the Federal Savings and Loan Insurance Corporation Protection Act, S. 1167. That bill would strike the requirements that: (1) the Bank Board, in considering such emergency authorizations, must give consideration to the maintenance of specialized depository institutions; and (2) the agency, in authorizing those transactions, must do so pursuant to a bidding and priority frameworth basically designed to give first preference to savings institutions from the same state (and to minority institutions with respect to acquisition of minority institutions).

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While the statutory framework admittedly would be somewhat easier to work with in the absence of the provisions sought to be deleted, we seriously doubt that it fairly can be blamed for causing FSLIC any excess costs with respect to assisted mergers. We must emphasize that the goals of ensuring continuation of depository specialization and local control are important ones that should continue to be linked to the emergency acquisitions authority. To reiterate, the League will resist strongly any attempt to delete these public-policy protections.

Another emergency provision that should be extended is section 121, which created section 5(p) of the Home Owners' Loan Act of 1933. Section 5(p) overrides any state or federal laws that might otherwise interfere with the Bank Board's authority to authorize mutual thrifts to convert to the federal stock form. Because the federal laws the provision was designed to override were eliminated by other permanent provisions of the Garn-St Germain Act, section 5(p) is of greatest significance to state-chartered institutions, with respect to which, of course, state law concerns remain significant.

One of the most important uses made of section 5(p) has been in connection with the Bank Board's modified conversion regulations. Under these regulations, converting, financially

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troubled organizations are allowed to restrict depositor subscription rights (the lower the entity's net worth, the greater the restriction allowed), thus making it easier for single investors to make substantial initial purchases of stock. This can be an essential ingredient in a successful conversion of an institution with low net worth, for capital injections under such circumstances are far more likely to come from persons or organizations seeking control than from large numbers of small investors.

Although, as indicated, section 5(p) appears primarily significant for state institutions, we note that the statute is cited by the Bank Board in its regulation as the official source of authority for any modified conversion of an institution, regardless of its source of charter.

A third emergency authority that merits extension is section 122(d)-(g). This provision -- subject to certain safeguards designed to accommodate dual system concerns -- basically gives the Bank Board (acting through the FSLIC) the same conservatorship/receivership authority over state-chartered institutions that it has over federals. Although our impression is that federal and state thrift regulators in recent years have cooperated very well in this area, section 122 assures the Bank Board of the ability to take prompt action in the event of a disagreement that the agency believes could result in unnecessary expense to the FSLIC.

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Policies Toward Failing Institutions

The third general question posed by the Committee raised a number of issues involving what policies should be observed with respect to failing institutions. In general, we feel that the deposit insurers should be allowed the widest scope of discretion in terms of the methods -- conservatorship, receivership, purchase and assumption, liquidation, capital or cash assistance -- used to deal with failing institutions, subject to several policy considerations that should be taken into account along with the cost minimization imperative.

Most notably, there should be a bias against leaving markets unserved by housing credit specialists or by depositories generally. In this regard, we believe public policy will be served best by an approach that favors preservation of the specialized savings institution identity. In addition, before a particularly powerful competitor is allowed into a weak market as a consequence of a supervisory acquisition, we believe the Bank Board, from its own self interest among other reasons, should analyze and take into account the likely impact of such entry on other FSLIC-insured institution to ensure that, ultimately, the transaction will not be more damaging than beneficial. Similarly, it is our

strong belief that institutions that are being kept alive through FSLIC assistance of some form should not be permitted, by virtue of that assistance, to engage in a strategy involving payment of significantly above-market rates on deposits. Such strategies are unfair to institutions not receiving FSLIC assistance, and only increase the FSLIC's exposure by sapping the strength of otherwise healthy thrifts.

Regarding the question of whether a supervisor should be able to require a merger before book insolvency, the U.S. League is not opposed to this in principle, for there are circumstances where such a step would be far less expensive to the deposit insurer than waiting for zero net worth to occur. But we would be very reluctant to see forced mergers authorized except with regard to institutions with very low net worth and in rapidly deteriorating condition. The judgment of government officials in these cases should not be substituted lightly for that of an institution's management, directors and shareholders.

Finally, with regard to improving the bidding process and reducing the cost of managing foreclosures, we believe the most significant step Congress could take would be to enact legislation, such as that represented by Appendix A, that would allow FSLIC to hire, fire and compensate its staff on a competitive, businesslike basis. Our perception is that most of the agency's problems in the areas in question are the

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legacy of a legal status that has demonstrated itself to be inconsistent with a timely, appropriate response to staffing needs. Of course, we also are convinced that the cost of managing failures could be reduced by adopting the U.S. League's Management Sharing Plan and through use of the special asset management subsidiary.

A final observation I would like to make in the general context of failing institutions concerns the impact on existing organizations of or granting them FSLIC insurance without regard to the question of the need for their services. Excess creation of institutions for which there is no economic need can only weaken existing institutions and the FSLIC, without generating any countervailing public benefit. In our view, it certainly would be poor public policy to put additional stress on the savings institution industry and the FSLIC where the tradeoff simply is to add incremental competition to what is already an extremely competitive marketplace. We hope you will seriously consider enacting legislation that restores economic need as a criteria in the granting of FSLIC insurance, thus overturning the decision in West Helena Savings and Loan Association v. Federal Home Loan Bank Board, 553 F.2d 1175 (8th Cir. 1977) which struck down agency regulations under which need was required to be demonstrated.

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Role of Private Insurance

The fourth question posed in the invitation to testify concerned whether there continues to be a role for private deposit insurance. We suspect that before very long any response we might offer may have been mooted by events; the Ohio and Maryland situations appear to have generated a powerful trend on the part of privately insured depositories toward obtaining federal deposit insurance (and, for the sake of stability, we hope the FDIC and FSLIC will do everything they can to expedite the processing of such insurance applicants).

As a matter of policy, however, we do not advocate outlawing private insurance, notwithstanding the serious misadventures of recent months. As long as depositors and investors clearly understand the risks involved, and adequate supervision exists, we see no reason, in a capitalist economy, why the private insurance option should be foreclosed. After all, over $200 billion is currently on pseudo-deposit in money market mutual funds without the protection of federal insurance.

In terms of specific safeguards, we would suggest that depositors in privately-insured thrifts be informed explicitly that no federal or state backing exists for their deposits. Indeed, to facilitate understanding on this point, it might be

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appropriate that the insurer be forbidden to use the name of a state as part of its corporate title. And, in terms of supervision, it appears clear that a high degree of strictness is in order. This is not to say that organizations in Ohio and Maryland were supervised any less vigilantly than their federally-insured brethren. Rather, it is by way of acknowledging the fact that the media can be relied upon to focus vast and confidence-eroding attention upon financial problems involving a privately-insured entity, thus putting such institutions in something of a "Caesar's wife" position.

Negative Impact of Tax Law Changes

As a final matter, it is important to remember, too, that the task confronting the savings industry and the FSLIC under review today by your distinguished Committee does not exist in isolation from other important issues pending before the Congress. In particular, the industry and its deposit insurer are impacted by proposals put forth in the Administration's proposal for tax simplification and reform.

I appreciate that your Committee does not have direct jurisdiction but there are three areas of particular concern in the proposal: repeal of the bad debt reserve methodology for thrift institutions' taxation and a recapture of a portion of past tax reserve accumulations; the transition to a new net

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operating loss carryback and carryforward pattern; and the sunsetting of special tax code provisions regarding FSLIC assistance and supervisory mergers.

The most onerous proposal would recapture a portion of bad debt accumulations equivalent to that reserved by commercial banks. Though the Administration's plan would spread this $2 billion tax liability over ten tax years, authoritative accounting treatment literature mandates that thrifts will have to recognize the entire new tax liability on their financial statements immediately, in contrast to commercial banks. The result is an industry-wide "hit" to net worth in 1986 of $2 billion -- reducing by one-third or two-fifths the net worth our organization projects will be rebuilt in the coming year if interest rates remain relatively stable. This portion of the Administration's proposal thus effectively contradicts the clear desire by many Members of this Committee and the Congress to encourage a stronger capital base for the savings institution business. It also complicates the task of the Federal Savings and Loan Insurance Corporation by adding potentially to its list of institutions which fail to meet minimum net worth requirements and by discouraging new buyers from acquiring capital-deficient institutions.

Another portion of the Administration's plan reorders the net operating loss carryforward and carryback which applies to

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savings institutions and commercial banks. Again a major problem is created in the lack of an orderly transition to the new method -- especially the failure to permit thrifts to utilize fully net operating losses already incurred. Not only does this impair the financial health of companies with significant net operating loss accumulations, but it also diminishes the appeal of savings institution acquisitions to new purchasers -- again potentially enlarging the task of the FSLIC in attracting merger candidates for troubled companies.

In testimony to be delivered later this month to the Finance Committee our organization will explain in greater detail why it is important to maintain some reserve treatment for savings institution tax purposes as well as the need for adequate net operating loss carryback and carryforward.

Yet another portion of the tax plan affects special provisions adopted at Federal Home Loan Bank Board request in the 1981 Economic Recovery Tax Act to permit the acquisition of a "financially troubled" thrift to qualify as a tax-free reorganization without regard to certain continuity of interest rules. A companion provision in the four-year-old law provides for tax-free treatment of certain FSLIC payments to the acquiring corporation. The Administration's request to the Congress would repeal these special tax code features in five years. Our organization would prefer a Congressional review at that time rather than an automatic sunset; furthermore, we see no rationale for confining these important supervisory merger tools to just the FSLIC -- they should be available to the FDIC as well.

Mr. Chairman, this concludes my remarks. I will be happy to try to answer any questions you may have.

Thank you.

APPENDIX A

98th CONGRESS
1st Session

S._____

IN THE SENATE OF THE UNITED STATES

Mr. _____ introduced the following bill; which was referred to the Committee on _____

A BILL

To revise the status of the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress Assembled

SECTION 1. The short title of this bill shall be the Savings Institutions Regulatory Improvements Act.

SEC. 2. Section 9101 of title 31, United States Code, is amended:

(a) in subsection (2) by redesignating paragraphs (G) through (J) as (I) through (L) respectively, and by adding the following two new paragraphs: "(G) the Federal Savings and Loan Insurance Corporation. (H) the Federal Home Loan Bank Board."; and

(b) in subsection (3) by striking out paragraph (E) and by redesignating paragraphs (F) through (M) as (E) through (L), respectively.

SEC. 3. Section 402 of the National Housing Act, as amended (12 U.S.C. 1725), is amended:

(a) in subsection (c), by striking, in the fourth sentence of paragraph (5) thereof, the words "governing the expenditures of public funds", and inserting in lieu thereof the following:", as now in effect or hereafter enacted, including without limitation any restrictions, statutory or otherwise, relating to personnel, or personnel employment levels, whether found in title 5 of the United States Code or elsewhere, or to apportionment of expense; and expenditures of the Corporation shall not be or be deemed to be from or of appropriations, appropriated amounts, or apportioned funds for the purposes of Title 31 of the United States Code or any other provision of law";

(b) in subsection (c) by striking the last sentence of paragraph (5) thereof and substituting therefor the

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following: "Notwithstanding any other provision of law, the Corporation is exempt from annual appropriation requirements and from budget review or approval by the Office of Management and Budget."; and (c) in subsection (d), by striking, in the second sentence thereof, (i) the words "in the Treasury" and substituting therefor the words "with the Treasurer of the United States in a special deposit account" and (ii) the period at the end thereof and substituting the words ", and shall be available, retroactively as well as prospectively, to be utilized by the Corporation for all purposes of the Corporation.".

SEC. 4. Section 19 of the Federal Home Loan Bank Act, as amended (12 U.S.C. 1439), is amended:

(a) by striking out the period in the first sentence and inserting in lieu thereof the following: "without regard to any other provision of law, as now or hereafter enacted, including without limitation any restrictions, statutory or otherwise, relating to personnel or personnel employment levels, whether found in title 5 of the United States Code or elsewhere, or to apportionment of expenses; and expenses of the Federal Home Loan Bank Board shall not be or be deemed to be from or of appropriations, appropriated amounts, or apportioned funds for the purposes of Title 31 of the United States Code or any other provision of law";

(b) by amending the third sentence thereof by striking the words "in the Treasury of the United States and may be from time to time withdrawn therefrom to defray the expenses of the Board, and the salaries of its members and employees" and substituting therefor the words "with the Treasurer of the United States in a special deposit account and shall be available, retroactively as well as prospectively, to be withdrawn by the Board for expenditures for all purposes of the Board"; and

(c) by striking out the fourth sentence thereof.

SEC. 5. Section 7(b) of the First Deficiency Appropriations Act (15 U.S.C. 712a(b)) is amended by striking the phrases "1. Federal Home Loan Bank Board;" and "11. Federal Savings and Loan Insurance Corporation;".

SEC. 6. Section 11 of the Permanent Appropriations Repeal Act, June 26, 1934, ch. 756, 48 Stat. 1224, 1229, is hereby repealed.

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SEC. 7. Section 9105 of Title 31, United States Code, is amended by striking the second sentence in paragraph (2) of subsection (a) thereof.

SEC. 8. Section 101 of the Independent Office Appropriations Act, 1944 (12 U.S.C. 1439a) is amended by striking out the phrase ", subject to subsections (a) and (b) of section 712a of Title 15" and by adding at the end of said section 101 the sentence "Notwithstanding any other provision of law, the Federal Home Loan Bank Board is exempt from annual appropriations requirements and from budget review or approval by the Office of Management and Budget.".

SEC. 9. Section 18(c) of the Federal Home Loan Bank Act, as amended (12 U.S.C. 1438(c)), is amended:

(a) in paragraph (1) , in the first sentence thereof, by striking the phrase "and subject to any limitation hereon which may hereafter be imposed in appropriation Acts,";

(b) in paragraph (5) by striking out in the first sentence the phrase ", and obligations and expenditures of the board and such agencies in connection with this subsection shall not be considered as administrative expenses"; and

(c) in paragraph (6), (i) by deleting in the first sentence the phrase "(A) annually prepare and submit a budget program as provided in Title I of the Government Corporation Control Act with regard to wholly owned Government corporations, and for purposes of this sentence, the terms 'wholly owned Government corporations' and 'Government corporations', wherever used in such section, shall include the board, and (B)"; and (ii) by deleting in the second sentence the phrase "first budget program shall be for the first full fiscal year beginning on or after the date of enactment of this subsection, and the ".

SEC. 10. Section 1 of the Reorganization Plan No. 6 of 1961, 75 Stat. 838, is amended: (1) by striking out clause (6); and (2) by striking out in clause (7) the words "for administrative expense purposes".

SEC. 11. Section 5B of the Federal Home Loan Bank Act, as amended (12 U.S.C. 1425b), is amended by deleting subsection (d).

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SEC. 12. Section 201 of the Independent Offices Appropriation Act, 1961 (12 U.S.C. 1438a) is amended by deleting the phrase "Provided Further, That hereafter expenses of the Board in making studies or investigations specifically directed by law, or requested by the Congress or either House thereof or by a committee of either House, including services authorized by section 15 of the Act of August 2, 1946 (5 U.S.C. 55a), shall be considered as non-administrative expenses:".

SEC. 13. Section 19 of the Federal Home Loan Bank Act, as amended (12 U.S.C. 1439), is amended by striking the last sentence thereof.

SEC. 14. Section 5(d)(9) of the Home Owners' Loan Act of 1933, as amended (12 U.S.C. 1464(d)(9)), is amended by striking the last sentence thereof.

SEC. 15. Section 407(m)(3) of the National Housing Act, as amended (12 U.S.C. 1730(m)(3)), is amended by striking the second to the last sentence.

SEC. 16. Section 408(h) of the National Housing Act, as amended (12 U.S.C. 1730a(h)), is amended by striking out paragraph (6).

SEC. 17. Notwithstanding any language found in sections 3 or 4 of this Act, nothing in this Act shall be construed to exempt the Federal Home Loan Bank Board or the Federal Savings and Loan Insurance Corporation from the application of any federal law (in effect as of the date of the enactment of this Act) relating to personnel that is applicable to a Federal Home Loan Bank.

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APPENDIX B

SECTION-BY-SECTION ANALYSIS

Section 1: Section 1 specifies that the bill's title is the Savings Institutions Regulatory Improvements Act.

Section 2: This section would provide the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation with "mixed-ownership government corporation" status. Such status, which already is enjoyed by the Federal Deposit Insurance Corporation and the Federal Home Loan Banks, would eliminate the need to observe a variety of requirements relating to obtaining budget approvals from the Office of Management and Budget and the Congress. Over time, these requirements have seriously reduced the ability of the Bank Board and the FSLIC to respond quickly and flexibly to the rapidly changing financial environment that shapes the exercise of their regulatory responsibilities.

Section 3: Section 3 would specify, first, that the FSLIC in spending money would not be bound by the normal federal agency requirements pertaining to such personnel-related matters as hiring, firing and compensation. This should prove extremely beneficial in terms of enabling the FSLIC to attract and retain the high quality employees it needs to perform its duties under the challenging circumstances now confronting it. In addition, section 3 would stipulate that FSLIC monies -- like those of the FDIC -- would not be regarded as being appropriated funds, and would not be subject to apportionment. Apportionment refers to a requirement that agencies must estimate what their expenses will be for each quarter of the coming year and obtain OMB approval before spending an amount in excess of the estimated sum. Further, this provision would make an explicit statement of exemption of the FSLIC from the appropriations process and from OMB budget review or approval. The non-appropriated-funds status of FSLIC monies would be reinforced further by a stipulation that such funds would be placed with the Treasurer of the United States in a special deposit account, rather than simply deposited in the Treasury, thus eliminating any possible conflict with the Constitutional admonition that funds are not to be withdrawn from the Treasury

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except pursuant to an appropriation. The amendment also would delete a reference to certain expenses of the FSLIC as being non-administrative, as opposed to administrative, expenses, a budgetary distinction that the Act would make obsolete.

Section 4: This section essentially would accomplish the same objectives for the Bank Board that Section 3 would for the FSLIC.

Section 5: This section would delete a requirement that Bank Board and FSLIC administrative expenses must be subject to the appropriations process.

Section 6: Section 6 would delete a provision stipulating that Bank Board assessments from the Federal Home Loan Banks shall be covered into the Treasury as miscellaneous receipts. According to Comptroller General Opinion A-62578, June 29, 1935, the provision effectively was repealed by Section 9 of the Act of May 28, 1935, which amended Section 19 of the Federal Home Loan Bank Act by saying that such assessments are to be deposited in the Treasury.

Section 7: Section 7 would delete a requirement that the Comptroller General audit the FSLIC and the FHLBanks on an annual basis, thus leaving the frequency of audits to the discretion of that official, subject to the general requirement that all government corporations must be audited at least once every 3 years.

Section 8: This section would eliminate a cross reference in the FHLBank Act to a provision the applicability of which to the Bank Board would be eliminated by section 5 of this bill. In addition, it would add to the FHLBank Act an explicit statement, basically identical to that which section 3 would add regarding the FSLIC, exempting the Bank Board from annual appropriations requirements and from OMB budget review or approval.

Section 9: Under Section 9, the Bank Board would be relieved of the requirement that it prepare an annual budget for OMB regarding the agency's building

and facilities. This would not affect, however, the requirement that the Bank Board maintain records regarding such building and facilities for annual audit by the General Accounting Office. Section 9 also would eliminate two provisions in the FHLBank Act specifying the non-administrative nature of certain expenses.

Section 10: Section 10 would strike a stipulation that the Chairman of the Bank Board is responsible for submitting a budget to OMB and justifying it to Congress. The section also would delete a reference to administrative expenses.

Section 11-16: These sections would eliminate various provisions stating that certain Bank Board or FSLIC expenses are to be considered as administrative expenses or non-administrative expenses.

Section 17: Section 17 would assure that the preemptive language employed in sections 3 and 4 with respect to personnel laws would not be construed to exempt the Bank Board or FSLIC from the application of, for example, federal anti-discrimination statutes; federal laws affecting personnel practices would continue to apply to the Bank Board and the FSLIC to the extent they applied to the FHLBanks.

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APPENDIX C

U.S. LEAGUE SUPPORTS NEW ENFORCEMENT POWERS FOR BANK BOARD

In terms of protecting the FSLIC, the Bank Board is keenly interested in upgrading its arsenal of enforcement tools in order to enable it to deal more effectively with some of the problems generated by "high-flier" institutions. The League, after long and detailed deliberations, has agreed to support important statutory changes in this area.

TEMPORARY CEASE-AND-DESIST ORDERS

Of these increased powers, the U.S. League believes that enhanced temporary cease-and-desist order authority would be among the most useful. Under present law, a temporary C&D -- which is, in effect, an administrative injunction -- may be used only where a violation of law, rule or regulation or an unsafe or unsound practice exists that could cause insolvency or substantial dissipation of assets or earnings, seriously weaken the condition of the insured institution or seriously prejudice the interests of its insured members. An institution facing such an order may contest it in U.S. District Court within 10 days of issuance; otherwise, the order remains effective until the underlying issues are adjudicated administratively.

The Bank Board, in its Insured Institutions Improvements Act, S. 759, is seeking to eliminate "substantial" and "seriously" as modifiers of the terms dissipation and weaken, respectively. The League has determined that we can support this, subject to several conditions. First, such orders should be in effect only for 60 days, after which the current standard would have to be met. We believe this would give the agency adequate time to deal with emergency situations with what amounts to the free hand available in the temporary order context, without substantially compromising the general principle that injunctive-style relief requires the meeting of very significant initial standards (e.g. irreparable injury).

Second, this extraordinary new authority would be subject to a 2-year sunset provision. This would provide Congress with an opportunity to assess, within a relatively short time frame, the manner in which the new authority had been exercised by the supervisory authorities.

Third, procedural safeguards should be implemented to ensure full review of relevant files by the Principal Supervisory Agent and the General Counsel, with the opportunity for an informal plea (absent emergency conditions) to the Bank Board members by the target prior to issuance of such an order,

with access by the target to the staff memo requesting the order. These safeguards are designed to underline the fact that the new temporary order is not something to be employed without the most serious review and consideration.

The League also has elected to support the Bank Board in its effort to obtain an additional temporary order that would allow the Bank Board to require cessation of any action the agency deemed appropriate if, because of incomplete or inaccurate records, the agency, after reasonable effort, was unable to determine an institution's financial condition. While we believe the above procedural safeguards should apply to record-keeping temporary orders as well, the League does not believe a sunset provision to be necessary, in light of the central and paramount importance of complete and accurate records to the supervision of our system of federally-insured depository institutions.

CEASE-AND-DESIST AUTHORITY

The Bank Board is also seeking to have persons filing (or required to file) a Change in Savings and Loan Control Act notice, and subsidiaries of service corporations added to the list of entities against which C&D orders (or temporary C&D orders) could be issued. In addition, orders could be issued against individuals who have resigned from a potential target organization and against an insured institution (or related individuals or an affiliate) during the two-year period after termination of insured institution status during which an institution still has insured accounts. The U.S. League has no objection to these proposals, provided the ability to obtain C&D orders against individuals who have resigned lasts only for two years after resignation. We believe this would represent a reasonable statute of limitations.

REMOVAL/PROHIBITION AUTHORITY

In addition to proposing increased temporary and standard cease-and-desist order authority, the Bank Board has requested greater removal and prohibition power, as well.

At present, removal/prohibition actions may be mounted against any officer or director of an insured institution, its service corporation or its holding company (or any subsidiary thereof) where, inter alia:

(1) there was (a)(i) a violation of a law, rule, regulation or cease-and-desist order which has become final;

(ii) an unsafe or unsound practice; or

(iii) a breach of fiduciary duty; and as a result,

(b)(i) the organization has suffered, or probably will suffer, substantial financial loss or other damage;

(ii) the interests of its insured members could be seriously prejudiced; or

(iii) the individual has received financial gain as a result of his conduct; and

(c) the conduct involved personal dishonesty, or has demonstrated or a willful or continuing disregard for the safety or soundness of the organization; or

(2) there was (a) conduct with respect to another business organization that resulted in substantial financial loss or other damage; and

(b) the conduct involved personal dishonesty or a willful or continuing disregard for the safety and soundness of the institution; and

(c) there is evidence of the individual's unfitness to continue as an officer or director.

Under the Bank Board's proposal, the "substantial" and "seriously" modifiers would be dropped from ¶1(b) and ¶2(a), breach of "professional duty" would be added to and equated with breach of fiduciary duty in ¶1(a), and receipt of financial gain would be added in ¶2(a) as the equivalent of loss to the employer. In addition, removal/prohibition actions could be taken against any person against whom a cease-and-desist order could be issued (subject, of course, to different criteria) and during the same period of time.

The League must decline to support the Bank Board's proposed elimination of "substantial" and "seriously" as modifiers, respectively, of the financial loss or prejudice to insured members' criteria, or its desired equation of breach of professional duty with breach of fiduciary duty as a removal criterion. The current removal standards generally seem suited to the seriousness of the penalty, and the League believes the weakening of those standards envisioned by the Bank Board would be inappropriate. In addition, we believe the concept of breach of professional duty is far too ambiguous for employment in the removal/prohibition context. The League supports, however, the Bank Board's proposed expansion of the list of

potential removal/prohibition order targets, as well as the equation sought by the agency of receipt of financial gain with loss to the employer.

AUTHORITY TO SEEK INJUNCTIONS

At present the Bank Board basically is required to seek correction of unsafe or unsound practices or violations of law or regulation through a procedure that permits recourse to the courts only upon appeal from the agency's final administrative adjudication of the matter. As part of its enforcement proposal, however, the Bank Board is seeking authority to go into U.S. District Court to obtain injunctions against such violations of unsafe or unsound practices when it determines that its administrative enforcement provisions are insufficient to resolve adequately the situation.

The League understands the Bank Board's desire to have a broad variety of rapid-acting enforcement tools, but we cannot support granting the agency a direct judicial injunction option. We believe the adverse publicity that necessarily would be associated with public court battles over Bank Board requests for equitable relief inevitably would be damaging to public confidence, not just in the target institution, but in other associations as well. Moreover, given the substantial increment of temporary C&D power -- which essentially is injunctive power -- that the Bank Board is seeking and that the U.S. League is willing to support, we fail to see any real need for placing this additional tool at the Bank Board's disposal.

CHANGES IN CONTROL

In our view, one of the key aspects of the Bank Board's request for additional enforcement authority is its inclusion of provisions designed to give the agency more power to scrutinize changes in control. Essentially, the Bank Board is asking for enhancement of its definitional power regarding key terms -- such as "control" and "acting in concert" -- used in the Savings and Loan Holding Company Amendments of 1967 and the Change in Savings and Loan Control Act. The League strongly supports the Bank Board's efforts to gain more authority to pass upon the suitability of those persons and organizations wishing to acquire control of FSLIC-insured institutions.

UNSAFE OR UNSOUND PRACTICES

Another component of the Bank Board's enforcement package that the League supports involves a codification of the definition of the term unsafe or unsound practices. Such practices, currently statutorily undefined, would be defined as encompassing "any action or omission which is, in the opinion of the [FSLIC], contrary to generally accepted standards of

prudent operation, whether relating to the association's internal management or to any external matter, the possible consequences of which, if continued, may pose abnormal risk of loss or damage to an insured institution or any subsidiary thereof, to its stockholders or accountholders or to the [FSLIC]."

Basically, this would incorporate into the statute, with some modification, explanatory language from a 1966 memorandum from then Bank Board Chairman John Horne to Congress regarding the meaning of the term unsafe or unsound practices. This memorandum is part of the legislative history of the Financial Institutions Supervisory Act of 1966, and at present represents the most authoritative definition of that term. Although, as noted, the League supports this definition, we urge that the legislative history of the proposed codification include language clearly indicating that, regarding external matters, it is not Congress' intent to have prudent managers classified as committing unsafe or unsound practices when they are victimized by conditions beyond their control, such as high interest rates.

INVESTIGATIVE AUTHORITY

A further feature of the Bank Board enforcement package that the U.S. League can support is its improvement of investigative authority. S. 759 would provide that entities that no longer have FSLIC insurance or that no longer are affiliated with FSLIC-insured organizations could be investigated by the Bank Board with regard to conduct that occurred when they were so insured or affiliated. This strikes us as a reasonable increment of authority that would help the agency better carry out its enforcement responsibilities.

SUBPOENA ENFORCEMENT

A final enforcement tool the League endorses involves the consequences of failure to obey a Bank Board subpoena. Under S. 759, failure, without just cause, to comply with a Bank Board subpoena would be made a misdemeanor punishable, upon conviction, by a fine of not more than $1,000 and/or imprisonment for a term of not more than one year. Again, we believe this is a reasonable provision that materially would assist the Bank Board in its enforcement efforts.

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APPENDIX D

AN ANALYSIS OF THE OPERATION OF AND NEED FOR THE NET WORTH CERTIFICATE PROGRAM

The U.S. League strongly urges the Congress to extend the net worth certificate program due to expire in October of this year. It is only in the last few months that interest rates have declined to a level that affords a real opportunity for the business to restructure and it will take some years before the majority of savings institutions will be in a position to live through a period of high interest rates without suffering significant losses. If interest rates remain low, the net worth certificate program would be relatively costless. If rates were to increase sharply, the certificate program would be an inexpensive way of helping the business weather the high rate period. If the program were allowed to expire, it would take time for Congress to reenact were it needed and the crisis atmosphere that such an effort would entail would further undermine a public confidence that has already been eroded by the difficulties at some large financial institutions and the problems with some of the state savings institution insurance funds.

So far, 94 FSLIC-insured savings institutions have participated in the program and the FSLIC has purchased a total of $129.6 million in net worth certificates. At this stage, no "real money" has been spent in the program since there is no cash involved in the transaction unless an institution has to be liquidated.

Of the 94 institutions, the League's Research Department has been able to identify 89 on the FHLBB's quarterly-report databank -- the others having merged out of existence. The 89 institutions had total assets of $23 billion at the end of last year. If these institutions had to be liquidated instead of being supported by the net worth certificate program, the total cost would have been $3.7 billion, using the 16%-of-assets cost figure that is frequently used in such instances. Given the fact that the FSLIC had total reserves of only $6.9 billion at the end of last year, $3.7 billion is an impressively large figure.

The number of institutions using the program is small but there are particular reasons why more did not elect to participate.

The Bank Board in office when the program was instituted was inimical to it. The general counsel for the Board at the time is quoted by the General Accounting Office as saying:

> "There should be every incentive for institutions not to participate in the program, or if they do . . . to graduate from it as quickly as possible. Therefore, participants should expect a certain degree of increased regulatory restraints and general operating discomforts."

At least in the beginning, the Bank Board made it difficult for institutions to participate. In particular, in the first four months after it started the program, the Board received 95 applications but only acted on 13 of them -- and of those, only four were approved and the others were either withdrawn or denied. Since interest rates were declining and conditions were beginning to improve in the industry, thereby reducing the need for institutions to get involved, the early delays were probably extremely important in keeping the number of participating institutions at a low level.

The processing delays resulted from two of the Bank Board's administrative requirements -- approval of institutions' appraised equity capital and submission of business plans as conditions of assistance. Neither of these requirements were set as conditions by the statute. According to a 1984 GAO report:

> "When institutions first began submitting required property appraisals, . . . Federal Home Loan banks began rejecting them for technical reasons. Some appraisals were rejected because they did not reflect highest market value according to Bank Board criteria; some applications were delayed because of confusion about when business plans were required -- before or after assistance was granted -- and about their content."

In addition to being an administrative headache, the requirement to recognize appraised equity capital before an institution was allowed to issue net worth certificates disqualified 125 institutions according to GAO estimates because it took them over the threshold 3% net worth ratio.

Furthermore, the Bank Board, in the beginning, was more miserly than the FDIC in the amount of assistance it would grant. When an institution first entered the program the Board would purchase only half of the certificates the institution was entitled to under the statute.

Also the act suggests that the agencies cover 70%, 60% or 50% of an institution's losses depending on whether the institution had a 1% , 2% or 3% net worth ratio, respectively.

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The Bank Board interpreted this to mean that it would first cover 70% of the losses up to the point at which it would bring the net worth, after assistance, to 1%. Then it would cover 60% of any remaining losses until the net worth ratio reached 2%. Finally, it would cover any more losses at 50% but only up to the point where the institution's net worth reached 3%.

According to the GAO, the Bank Board's assistance formula:

> "compared to the assistance allowed by the act's formula and available under FDIC's program, tended to decrease the amount of assistance available to qualified institutions. The act does not provide for the tiering calculation, nor for capping assistance at 3 percent net worth. FDIC, while capping assistance at 3 percent net worth level, does not use a tiering calculation when determining assistance amounts."

Under the chairmanship of Edwin Gray, the Federal Home Loan Bank Board liberalized the program. In September 1984, the Board eliminated the reduced initial assistance formula and the tiering calculation. The new formula provides for assistance at the maximum 70% suggested by the act with a cap at the 3%-of-assets net worth level.

In a new July 1985 report, the GAO found that the Bank Board and the FDIC were operating the programs in a manner that followed the intent of Congress:

> "We saw no indications of either agency departing from established statutory and regulatory eligibility criteria. Thus, we concluded that each agency was consistently applying its own eligibility requirements in granting thrifts net worth certificate assistance."

In the July report, the GAO pointed out that institutions that are receiving net worth certificates continued to lose money in 1984 while the business as a whole was profitable. The business, in the aggregate, was profitable in 1984, though only barely so. The return on assets for the year was only 0.14% and almost one-third of the industry was still losing money in the first quarter of 1985. Thus, it should not be surprising that institutions that were weak enough to qualify for assistance in the first place were still showing losses in 1984. Furthermore, the 89 institutions that we have been able to trace made considerable progress in reducing their loss levels throughout the year. The aggregate annualized quarterly return on assets was as follows:

First Quarter, 1984	-0.80%
Second Quarter, 1984	-0.32%
Third Quarter, 1984	-0.59%
Fourth Quarter, 1984	-0.28%

Also 14 of the 89 institutions made money in the first quarter last year and, by the fourth quarter, 31 were in the black.

For the business as a whole, our preliminary results show that the second quarter of 1985 showed a strong pick-up in profitability levels. We would suggest that the second quarter results are the ones to look at for the institutions that are in the net worth certificate program if one is trying to determine their ability to return to profitability.

In May of 1985, the GAO released, without comment, a series of tables comparing institutions that have received net worth certificates with the business as a whole. One of these tables shows that the portion of assets in the form of fixed rate mortgages fell from 77.0% to 61.3% between December 1982 and September 1984 for those institutions receiving assistance. This decline of 15.7 percentage points compares with a decline of 18.9 percentage points for the business as a whole, where fixed rate mortgages fell from 72.1% to 53.2%.

Similarly, the percentage of assets in the form of ARMs for assisted institutions rose from 3.2% to 17.2% compared to a rise from 6.8% to 21.9% for all institutions. Although the GAO does not explicitly say so, one presumes that these figures are presented to show that institutions receiving net worth certificates are making less progress towards restructuring than the average institution. Again, these findings are not surprising. Many of the assisted institutions are located in areas where the real estate market is not as buoyant as in other areas and the fact that they have made only a little bit less progress in restructuring than the rest of the business argues on behalf of the continuation of the program.

In sum, it would appear very beneficial for the Congress to renew the program. It gives the regulators additional flexibility in dealing with problems, particularly the problems that would arise if interest rates were to climb again. It does not reduce the regulators' authority and flexibility in disposing of problem cases if the opportunity to do so exists. In fact, one of the explicit requirements of the Bank Board that must be met before an institution can issue net worth certificates is that a merger that would reduce the need for assistance is not available.

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The CHAIRMAN. Thank you, Mr. Levy.

Gentlemen, both the U.S. League and the National Council have endorsed the extension of the Net Worth Certificate Program. Yet, GAO has done a study that indicates the net worth certificate recipients have continued to deteriorate for the most part. That isn't true of all of them but generally that is true.

Would both of you comment on your opinions about the GAO study?

GAO STUDY DATA

Mr. ALBERS. It is my understanding, Senator, that the GAO study uses June 1984 data. There has been dramatic changes in the interest rate structure since then, and in my summary and written statement I did note the close-to-record earnings being achieved by the thrift industry since then. So I think that study, while it might have been correct at that time, if updated, would show very different results.

The CHAIRMAN. Well, let me just follow up—you continue to mention and I mentioned earlier that the industry as a whole is having record profits. That's true. But we've got more institutions in trouble nevertheless, despite the fact some are doing very well and when you look at an industrywide average it shows good profits. We've got some real problems with thrift institutions.

Mr. ALBERS. Many of the problem institutions we now have are due to bad assets which is not what the Net Worth Program was aimed at. Banks participating in that program have taken advantage of the timeframe to modify their asset structure, try to become a little more liquid, and better match their assets and liablities. Variable rate mortgages is one approach but there are many other things that institutions have done, for example, shifting to long-term certificates of deposit, that helps extend the liability side a bit.

So I think many of the institutions are taking advantage of the present interest rate environment—if this is indeed a hiatus—to restructure their assets so that they can meet even an increase in rates.

The CHAIRMAN. Should we limit it only to those who are restructuring? Should we limit the application of net worth certificates only to those who are restructuring? GAO pointed out that some of them weren't. They were continuing to deteriorate and were not solving their problems. In other words, should we say only those who can take advantage of this help are those who are attempting to improve and to restructure?

Mr. ALBERS. Well, in our statemment we said that effectively on the savings bank side the situation has dramatically improved. Now, 7 or 8 are no longer with us, but the 20-some-odd that are have shown real improvement. I don't have figures on the S&L side since the National Council does not have a great many members on the savings and loan side receiving aid. It would be my personal opinion that a CEO of an institution in trouble certainly would be doing whatever he or she could do to modify their situation and take advantage of the time of lower rates, but I don't have detailed information on it.

Mr. LEVY. Senator, I would add this. I was pleased to hear that Ken pointed out that the savings banks are all reaching a profitable level. There was a story in the New York Times just the other day about net worth certificates and the liferaft.

I look at this as maintaining a safety net. I, too, was disappointed to see the action on the deficit and on the budget bill. If some of the doomsayers are right, and we're heading back toward higher interest rates, of course, these earnings are going to begin to disappear, so I think this would certainly be the wrong time to remove that safety net. Efforts are being made to deal with these institutions and I think it is very important that it be kept in place.

I sat here listening to the comments about the Continental Bank and I thought to myself that one can talk about sending a different message, but would it be credible? The Congress could deal with it by passing laws that say that the Continental-type situation could never take place again, but would you want that in place when you really don't know what the next crisis might be? I mean, you wouldn't want to limit the ability of the regulators to deal with the crisis as it occurred. And I think in dealing with net worth certificates, having the authority in place, having it available to the regulators, is very important.

The CHAIRMAN. Assuming we do continue it, do you recommend any changes be made, either one of you?

Mr. LEVY. No, apart from the adjustments we testified in favor of in June. I think the extent of the usage has been less than forecast but it is an important tool and I think it should be continued.

Mr. ALBERS. I don't see any great modification needed, no.

The CHAIRMAN. Senator Proxmire.

434 INSOLVENT S&L'S AT THE END OF 1984

Senator PROXMIRE. Mr. Levy, you strongly oppose the proposal to merge FSLIC and FDIC insurance funds. At the same time, at the end of 1984, there were 434 insolvent savings and loan associations. That is, they had negative net worth. The staff of the Federal Home Loan Bank Board has estimated that if these insolvencies were closed the cost to FSLIC would be over $15 billion. As you know, FSLIC has an unencumbered reserve of less than $6 billion.

How do you believe the Bank Board can make up the deficiencies in the FSLIC? Do you really believe the proposals you suggested will handle a problem of that size, particularly if we have, as you say we might—we have to be prepared for it in any case—a sharp rise in interest rates?

Mr. LEVY. Well, first of all, the statistics you cite were as of the end of 1984 and the change in the earnings position of the savings and loans during 1985 has truly been dramatic: some $500 million in earnings in the first quarter and upwards of $1½ billion in the second quarter, or some $2 billion in the first half.

Senator Garn is correct, if that were evenly apportioned among all the institutions, a lot of our problems would be solved. But the fact is, in this third quarter, all but a handful of institutions will have reached the profitability area. A lot of the institutions in that 400 number that you're citing are institutions that are dealing

with low-yield portfolios and those people have been reporting profits.

Senator PROXMIRE. Let me just interrupt to ask you what has happened in the last couple years to assure us that we won't get into the same jam again? After all, we're all familiar with the terrible problem with the deficit. We've been through recessions before. Some people feel the next recession could be much worse than the last one.

Why are we in a position with your industry, to weather the storm better than we did in the past?

Mr. LEVY. Well, I think we're improving in several ways. First of all, we're almost 5 years in from the Fed action back in 1979–80. A lot of that old portfolio has been rolling off. Sometime in the early 1990's, through just normal repayment, most of those 8.5 to 9 percent loans are going to be gone. And I would point out that those loans are very safe. The principal will be repaid.

Second, there has been restructuring taking place. If you look at the mortgage markets, as high as 70 percent of the loans originated by savings and loans have been adjustable rate loans. Many of the institutions are building up 40 to 50 percent of their existing portfolios in the adjustable rate mortgages.

Senator PROXMIRE. Overall, do you have statistics to indicate what proportion are adjustable rate mortgages now?

Mr. LEVY. We've been as high as origination levels of 70 percent.

Senator PROXMIRE. Yes, but I'm not asking that. My question is how much of the present portfolios?

Mr. LEVY. I would say that the present portfolios have now reached probably 35 to 40 percent.

Senator PROXMIRE. And it's improving——

Mr. LEVY. Consistently. But one has to look at the other. It's not a case of looking at the other 30 to 35 percent and assuming that's all 30-year fixed rate lending. There's a new instrument that's become very popular within the last year—the 15-year fully amortizing loan, which on a duration basis is 5-year paper. Many institutions are originating those and matching them up with longer term deposits.

IMPROVED SITUATION THROUGH RESTRUCTURING

So I think there's a considerable amount of restructuring that is going on and will continue to go on and I think the situation is improving.

Senator PROXMIRE. Now on July 25, Chairman Gray of the Home Loan Bank Board told us there was increasing concern about the powers given by some States to thrifts that are insured by FSLIC. He said his agency:

> * * * has taken the position that in the Garn-St Germain Act Congress determined what activities it thought were suitable for federally insured thrifts.

Using this rationale, he said the Home Loan Bank Board believes that activities which go beyond these limits ought to be subject to supplementary premium pricing based on the risk of loss to the fund such additional activities pose.

Do you agree with that concept and, if not, why not?

Mr. LEVY. Yes, we agree with that, subject to the limitations outlined in our written statement. Now let's take it a step further, and this is one of the points made by the earlier panel. The question is whether, through a risk premium, through a cash payment, whether enough disincentive can be built in to amortize the risk involved. We strongly take the position that the risk premium should be incorporated with increased net worth requirements: That there should be a combination of net worth and premium payment. And I emphasize, we focus this on powers beyond those contained in that last bill; that is, real estate development and nonfinancial activities.

So yes, we support risk proposals, but I think the premiums can't be set high enough to alter conduct. I think it has to be a combination of premiums and net worth. If people are willing to put up their own capital and put it at risk and use that as a buffer and a cushion to protect the FSLIC, then I'm not concerned with that. I think people should be in that position.

Senator PROXMIRE. Both Chairman Gray and Chairman Isaac have argued that brokered deposits pose significant dangers to the health of our financial system. Chairman Gray even calls them a "cancer on the thrift industry." Former Comptroller of the Currency Conover, by way of contrast, has said not to worry about brokered deposits; they're OK, although some upper limit on them might need to be established.

What's your view—and I'd like Mr. Albers' view too—on brokered deposits as related to the health of the thrift industry? Should we limit them in some way?

Mr. LEVY. Well, I would agree that they should be limited. I'm not prepared to say they should be eliminated, but I think it would be appropriate if they were limited along the lines of some of the proposals we've seen. An institution shouldn't have 80 or 90 percent of its deposits as brokered deposits which are ready to flee on short notice and/or are subject to payment at very high rates of interest that then require taking of unusual risks on the asset side. I think that clearly causes undue risk for the fund. Again, I would support limitations of the amount of brokered deposits that could be handled by thrifts.

Senator PROXMIRE. Mr. Albers.

Mr. ALBERS. Our opinion would parallel what Mr. Levy has said. I don't think brokered deposits should be eliminated. They can be a valuable source of transferring capital or money around the country from an area with an oversupply to an area with an undersupply. Many institutions have used brokered deposits and have used them prudently. The ones that make the headlines, unfortunately, are the ones that have not used them prudently.

So I believe in some type of restriction so that individual institutions cannot abuse the privilege, but I think brokered deposits per se do have a place on the American financial scene.

UNIFORM MINIMUM CAPITAL STANDARDS

Senator PROXMIRE. Now the Bush task force has told us that the Congress should set uniform minimum capital standards applicable to all insured banks and thrifts.

Do you two agree with that recommendation? If so, why? If not, why not?

Mr. LEVY. I think setting of capital standards is very important. I think if you look at the Bank Board regulation that went into effect the first of the year, the new growth restriction requirement that is part of the net worth requirement that the Bank Board handed down, you will see the result was a heartening change in the growth rates. In 1983 and 1984 the business grew at something close to a 19 to 20 percent rate and it's growing at just over 6 percent in 1985. I think it's very important.

I have probably a stronger personal position than our current position within the U.S. League. I think that it's imperative to build capital positions. Wisconsin, as you know, is a State where savings and loans were not permitted to use anything but generally accepted accounting principles [GAAP] accounting. We have very strong capital positions and I think that ultimately the strength and the protection of the FSLIC will be built by building the capital position of the business. When you look at a year developing where we can earn something over $5 billion, with that kind of money pumped into the capital positions of the institutions, I think that is something that is just extraordinary.

Senator PROXMIRE. Do you think capital accounting requirements should be a national policy?

Mr. LEVY. Well, ultimately. The question is how soon. You have to recognize the current problems, but I think over the long term we will ultimately have to come back to both stronger capital positions and different accounting. It's just a matter of the institutions working out of their problems and working toward the 1990's and strengthening themselves.

Mr. ALBERS. I, too, am in accord with that. My bank, the Provident, is an FDIC-insured bank, so we're under GAAP accounting. We have been following that since the bank was organized.

I think you have to recognize however, that you can't unscramble the egg. Regulatory accounting principles were granted to many of the savings and loan associations, especially the nonpublic ones, and many of them have acted upon this. They have sold low-yielding long-term mortgages and are using the regulatory accounting as part of the work act process. The rules cannot be changed too suddenly. So that at some point in the future I think we should be under consistent capital rules, both how it's calculated and what the various capital levels should be based on the risks an individual institution is taking.

Mr. LEVY. If I may add a point, in the earlier panel Senator Garn raised the question of deregulation and the problems we see. I don't really look to the linkage between deregulation and these problems.

I think the problem was that when we deregulated we really didn't have capital requirements in place. There was a lack of linkage between growth and capital. It was the ability to grow, not just the ability to use broader powers, that came about in linkage with deregulation that I think caused a lot of the problems we're seeing today.

Senator PROXMIRE. My time is up, Mr. Chairman. I have a couple questions for the record. I would appreciate it if the witnesses could answer them.

The CHAIRMAN. Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

Mr. Levy, it's my understanding that withdrawals at federally insured thrift institutions exceeded new deposits by $1.4 billion in July and that's the fourth monthly net outflow of capital this year.

Now how do you account for this substantial outflow of capital and what are the implications for the S&L industry?

Mr. LEVY. Well, to clarify, when I use the term capital I'm using it as a synonym for net worth. What we're talking about are savings deposits that have been flowing out, not capital.

In a way, my first response to you is I think I'm a little encouraged by that.

Senator SASSER. How so?

Mr. LEVY. Well, after looking at 1983 and 1984, we went through 2 extraordinary years of growth. Now there's a very simple reason for that growth: rates substantially above market rates were being paid for deposits. I think what we're seeing nationally is a more sensible approach to pricing savings products and some outflow that's very modest—we're talking about a $1 trillion industry and I think it reflects a more conservative approach to management. Frankly I'm encouraged by it.

Senator SASSER. Well, what discussions, Mr. Levy, and what support, if any, have you received from Chairman Gray at the Federal Home Loan Bank Board with respect to the proposal for the formation of a new corporation to assume ownership of nonproductive assets that are now held by the FSLIC?

Mr. LEVY. Well, I think the response we're going to receive from them ultimately is going to be very favorable. I referred earlier to the problem of staffing. They have some 20 or 25 people in their liquidation section. Clearly, they could go out and hire, I suppose, consultants or outside people in a different capacity. But we think the best idea is putting these assets together in a single corporation and attracting people from the real estate work-out community who would be hired on an incentive basis and would deal with the real estate in the way it's been dealt with in the past. After all, if we go back to the 1974–75 period and the problems the real estate investment trusts [REIT's] had with real estate disposal, it was first thought that they would be lucky to get 50 cents on the dollar. As it turned out, they got closer to 80 cents on the dollar because they were able to professionally manage and move that property over a period of time. They weren't in a fire sale situation. They were able to develop financing methods and move it through professionally. And I think having that available in a concentrated central way here is going to be an extraordinary benefit to both the fund and to the Federal Home Loan Bank Board and ultimately to all of us.

Senator SASSER. So I take it that Chairman Gray supports this concept?

Mr. LEVY. My understanding is that they are receptive to the idea, yes.

Senator SASSER. What would be the relationship of this new agency to the FSLIC?

Mr. LEVY. Well, maybe I should clarify. I don't see this as Federal agency. What we're talking about doing is chartering a Federal savings and loan association.

Senator SASSER. It would be a quasi-governmental agency but would not need congressional approval, as I understand it, and would be designed to buy billions of dollars' worth of troubled assets from the FSLIC and the loans would come from the 12 Federal home loan banks. Is that correct?

Mr. LEVY. Well, no, I think I'd clarify that. The FSLIC real estate, some $2.3 billion, would come in on a liquidated basis, a market value basis, to this new corporation. The FSLIC would receive notes for a portion and stock for the balance. Let's assume they started with $400 or $500 million as a capital contribution. They would receive the balance of $1.8 billion in notes. Additionally, the Federal home loan banks would purchase stock out of their undivided profits. As I say, they're in an extraordinarily well-capitalized position and they would purchase stock. Initially, it's talked in the $300 to $400 million range, but in the discussions we've talked about the ability to go up to $1 billion in the purchase of stock.

Now the borrowings—I think that's where we get confused—wouldn't have to come from the Federal Home Loan Bank System. Remember, what we're talking about is effectively a savings and loan at that moment with notes out, with substantial capital, and the ability to go to any capital market—to attract funds in any way. It wouldn't necessarily use the Federal Home Loan Bank System. They could attract funds directly because they are an independent corporation. They are not an agency. And they would then be in a position to start the disposal process.

Senator SASSER. I suppose this is an elementary question, but why is this necessary now?

Mr. LEVY. Well, I suppose one could say that you could expand the FSLIC and go out and hire people and carry on the function through the FSLIC. No. 1, we need legislation to move them away from OMB and other restrictions in terms of expanding personnel. No. 2, I think we are basically talking about the need for very different kinds of people. The people that work as work-out specialists on real estate work on an incentive basis. They're not attracted on a normal salaried basis. I think what we need are real shrewd operators. The people who will be coming to purchase these assets certainly come from a private sector, from a profit orientation, and they sense that they're going to be able to deal on almost a fire sale basis with the FSLIC. And what we need on the other side to maximize the return on the sale of those assets are the same breed of cat. We need people that really understand how to deal in that environment. And again, I don't see them as an agency any more than the savings and loan I operate is an agency. The savings and loan I operate operates under a Federal insurance of accounts rules. This is a new savings and loan specifically designed for one purpose and that's to dispose of this real estate on an orderly basis to obtain the best price available.

Mr. ALBERS. I think what we're talking about is another arrow to put in the quiver. We have been concentrating very much on the number of savings and loans presently in trouble. One key part of the solution this special purpose corporation on which the League and the National Council may differ on some of the mechanics, but the essence of what we're saying is very similar.

What the FSLIC has to do is recognize that an institution is getting in trouble before it's too far gone. We need an early warning system. And we've suggested 2 years in our program. Then the Home Loan Bank or FSLIC comes in and says, "You have 1 year to do these kind of things to turn your situation around." If not, they step in and try to find a merger partner. Failing that, stronger steps are taken so that when the assets hit this corporation it is not a defunct institution. It merely gives them alternative. They tried closing them; they've tried management contracts on others and another, we think this is the alternative that makes sense. This is the one that's going to do the most for the FSLIC, the most for the industry over the long term, and cost the least amount of money to everyone involved.

So we feel this is a very key thing. As Mr. Levy said, you need people with somewhat different expertise, hence a separate corporation.

Senator SASSER. You need somebody other than liquidators?

Mr. ALBERS. Yes.

Senator SASSER. I've had some experience with those liquidators. I'm not sure they get the full dollar value.

Mr. LEVY. Let me just add the other point is that in transferring the assets, these bad assets, you then end up with an institution that has a liability structure and has remaining assets and has a charter to do business. It puts the FSLIC in the position of being able to dispose of the institution through a bidding process and, again I would say, with the bad assets stripped out, probably at a premium. So it gives them a chance for some recouping on that side as well.

Mr. ALBERS. The franchise would have that.

Senator SASSER. Thank you, gentlemen.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Albers and Mr. Levy, thank you very much. Your testimony has been very helpful and very informative. There will be some additional questions for your response in writing.

The committee is adjourned.

[Whereupon, at 11:30 a.m., the hearing was adjourned.]

[Response to written questions from Kenneth F.X. Albers and Gerald Levy follow:]

National Council of Savings Institutions

Jim Cousins
Vice President and Director
Congressional Affairs

Dear Senator Garn:

Enclosed are my responses to the questions posed by yourself and Senator Proxmire with regard to Ken Albers' testimony of September 10 on deposit insurance reform.

QUESTIONS FROM SENATOR GARN

1. What is your view of the National Council Task Force's proposal for risk-based net worth and a definitive time frame for an institution to come into compliance, or find a merger partner, or be placed into receivership?

I agree with the task force recommendation. The task force had some difficult decisions to make and recommended some tough compliance standards. They are appropriate in the present climate.

2. With regard to the proposed asset management subsidiary, is the real advantage the ability to manage problem assets outside the ceiling of federal pay caps? Isn't a disadvantage that the value of such assets decline if they had to be disposed of on a stand alone basis--as opposed to being in a package of good assets and solid customers to be sold as a going concern? What are the pros and cons of one asset management subsidiary versus twelve?

There are multiple advantages. The most obvious is that the "406" Corporation would be able to hire an adequate staff skilled in the management of real estate. The present staff of FSLIC is neither large enough nor possesses the proper experience for the job. We believe that one corporation is less desirable because the real estate markets vary from place to place and we would prefer to keep the authority as close as possible to the problems.

3. If a substantial amount of the Home Loan Banks' assets consisted of loans to the FSLIC, could this severely lessen the willingness of the private sector to invest in a Home Loan Bank's debt instruments. Why or why not? Currently what is the total excess debt capacity of the regional Home Loan Banks?

Confidence in the FSLIC by "the market" is the key here. If the market perceives a sound FSLIC and prudent handling of problem cases and problem assets then this should reflect positively in rates paid for funds by the Home Loan Banks.

4. At what point would loans from the Home Loan Banks begin to impair the confidence of the private sector investors in the Home Loan Banks' debt obligations?

If the systems funds were used to support the weakest assets of the insured institutions and were perceived as not contributing to the health of the overall system, the confidence of investors would surely decline.

5. The primary supervision of thrifts has already been delegated to the local Federal Home Loan Banks. If the disposition of problem institutions were also delegated to the local banks, what would be left for the Bank Board?

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Wouldn't there be a danger of the Bank Board losing control?

The FHLBB still writes the regulations and sets the standards by which examination and supervision is coordinated. No one is suggesting any diminution of the Board's primary role and authority.

6. Should the FSLIC require its insureds to make a one percent deposit in the fund? Why or why not?

Not at this time. Such an action would put 50 to 100 marginal institutions into insolvency and just make the whole situation worse. Other solutions such as "406" and a more aggressive effort to sell problem institutions to any and all potential buyers would be far better solutions than draining the lifeblood of healthy institutions.

7. If the FSLIC and the FDIC funds are not merged, where will the FSLIC obtain sufficient funds to deal with its problems over time?

FSLIC has a projected cash flow of $2 billion per year which is sufficient when coupled with proper marshalling of resources and proper attention to enforcement as detailed in our written testimony.

8. With regard to other forms of market discipline by uninsured depositors and general creditors, it is argued that the market discipline is fickle, is trendy. Indeed, it is argued that a run is the ultimate form of market discipline. How do you respond to these concerns?

A run represents the ultimate failure of the industry and its regulatory structure to maintain public confidence. Public confidence is the ultimate bottom line. It cannot be maintained forever by propping up failed institutions.

9. Should the FSLIC be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed bank with any profit after administrative costs arising from the transaction returned to the original stockholders?

Theoretically, it should be possible to force a merger and still protect the interest of shareholders of the acquired institution. Assuming such protection and such a merger would protect the interests of the FSLIC. As a practical matter this kind of policy would almost certainly end up in court.

10. If the burden of mismanagement was placed squarely and directly on the managers and stockholders, is it necessary to punish depositors and borrowers in order to achieve an improved supervisory system? If failures were handled through a purchase and assumption or forced merger at an earlier stage, regardless of size, wouldn't this dispose of the fairness

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question as it relates to large and small institutions?

It is beneficial to the system as a whole to try to resolve problems at the earliest possible stage. It is not clear, however, that this alone resolves the "size" issue. The fact remains that (at any stage) it is harder to arrange a purchase and assumption for a large shop than for a small one.

11. In your opinion, what are the advantages and disadvantages of risk-based capital and risk-based premiums? Should we consider one or the other or both?

The two approaches share one common problem--the subjectivity of risk. Our recommendation is for a "whole institution" evaluation rather than looking at individual types of investment activity in order to reduce the subjectivity. We also believe that the capital approach is preferable because it is a tougher standard and therefore results in greater discipline.

12. There appears to be strong support for risk-based capital in some form. Some suggest an adoption of risk-based capital by the federal insurance agencies would give them the necessary authorities to regulate the activities of state-chartered institutions without granting the authority to override a state legislature. What is your view?

We agree with this point of view. If an insured institution is sufficiently capitalized then the insurance fund is protected and need not rely on prohibitive regulations of state authorized business decisions.

13. How would you recommend resolving the dilemma to the dual banking system created by states authorizing activities which place the federal insuring agencies at risk?

We believe that the imposition of risk-based capital standards will resolve this problem area in a more satisfactory way than any of the alternatives. Also, proper supervision, through examination and prompt enforcement should prevent improper and imprudent exercise of authority.

14. Do you believe that the FHLBB and/or FSLIC needs increased enforcement authority? If so, in what areas?

No, they currently have sufficient statutory authority. They need to enforce their regulations more vigorously and more personnel to enforce compliance.

15. Does the Community Savings and Loan and EPIC problem reinforce the need for certain activities to be engaged through a subsidiary of the holding company rather than a subsidiary of a depository institution?

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No, the public perception of the link between EPIC and the S/L would be the same in either case.

16. How can or should we determine if the size of the insurance fund is sufficient and will continue to be sufficient to assure confidence and manage the costs of potential failures?

Sufficiency is always a relative term. The fund is sufficient or not relative to the financial condition of the insured industry as a whole. Therefore, there is no specific dollar figure we can give you and say it is "sufficient."

17. Are there any provisions in the proposed tax legislation which would have an adverse effect on savings and loans? On potential savings and loan mergers? If so, please explain.

There are at least two clear problem areas in Treasury II. The proposal that past years bad debt reserves be taken into current income (the recapture issue) would be devastating to the industry. A very large part of the industry's profit would be lost and marginal shops could be forced into insolvency.

On the specific issue of mergers and acquisitions of problem shops there is a proposal in Treasury II that would repeal the tax exempt treatment of FSLIC assistance given in supervisory mergers. Taking that tax treatment, the cost of such mergers to the FSLIC must go up proportionately. Rather than repeal the provision--we propose that it be retained and that similar treatment be accorded to FDIC assistance.

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QUESTIONS FROM SENATOR PROXMIRE

1. Mr. Pratt, the former chairman of the Federal Home Loan Bank Board, told us on July 25 that the "greater success of the FDIC as compared with the FSLIC has been simply a result of the fact that greater capital is required for banks as opposed to thrifts." He noted as well that in light of this "maybe variable capital requirements make more sense than variable risk premiums..." What do you think of this concept? What measure can we take to raise the capital requirements of FSLIC insured thrifts?

We do agree that the variable capital approach is preferable. It will probably instill more discipline and caution in decision-makers than the premium approach.

Capital can be raised in our institutions in a number of ways--retained earnings and attracting new capital by conversion to stock form or selling new stock, or finally, by the acquisition of a charter by a firm with capital to commit to the savings and loan. The best help Congress can give is not to place barriers in the way of any of the processes. I refer to arbitrary asset composition tests, limits on cross-selling of services and limits on the ownership of savings and loans--all of which have been proposed in Congress in recent years.

2. One critique of risk based premiums is that weak thrift institutions would make even riskier loans to make up the cost of higher insurance premiums. Do you agree with this criticism?

Yes we agree. That is one reason why we favor the capital approach over the premium approach.

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USL
UNITED STATES LEAGUE of SAVINGS INSTITUTIONS 111 EAST WACKER DR. / CHICAGO, ILLINOIS 60601 / TEL. (312) 644-3100

November 13, 1985

The Honorable Jake Garn
Chairman
United States Senate
Committee on Banking, Housing
and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Garn:

The U.S. League of Savings Institutions is pleased to respond to the additional questions put forth by you and by Senator Proxmire in order to complete the record of your Committee's September 10 hearing on the subject of deposit insurance reform.

1) What is your view of the National Council Task Force's proposal for risk-based net worth and a definitive time frame for an institution to come into compliance, or find a merger partner, or be placed into receivership?

We noted in our testimony that risk-based net worth requirements are an attractive alternative in that they avoid the need, unlike the case with risk-based premiums, to expense the full cost of behavior modification. Accordingly, we have urged that, in order to develop hard data in this general area, Congress authorize a two-year experimented risk-based premium program that would be integrated with variable net worth requirements. In terms of the actual application of such requirements, the League does not advocate the kind of holistic approach embraced by the National Council, for we think it would leave far too much room for examiner subjectivity. In our view, it would be more appropriate to focus on specific problem investment areas such as real estate development and other non-financial activities. Regarding the question of whether some specific timeframes and sanctions should be established for capital-deficient institutions, we would not favor an approach that deprived regulators of their ability to tailor supervision to the specific demands of individual cases and the overall economic environment. Any capital rebuilding schedule which looks feasible at today's level of interest rates could quickly become unrealistic if interest rates ratchet up once more. We are particularly apprehensive that inflexible deadlines would only encourage institutions with low

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net worth to engage in irresponsible "end-game" strategies to reverse their fortunes.

2) With regard to the proposed asset management subsidiary, is the real advantage the ability to manage problem assets outside the ceiling of federal pay caps? Isn't a disadvantage that the value of such assets would decline if they had to be disposed of on a stand alone basis - as opposed to being in a package of good assets and solid customers to be sold as a going concern? What are the pros and cons of one asset management subsidiary versus twelve?

As is suggested, the primary economic benefit of the asset management subsidiary is the ability to manage problem assets free of the counterproductive personnel and other restrictions associated with federal agency status. Another benefit is the ability of such a corporation to cash the FSLIC out of physical real estate assets and thereby improve the "unobligated balance" measure of FSLIC capacity. Concerning the question of whether the assets to be managed could be disposed of more profitably if they were part of a going concern, our understanding is that the subsidiary is designed to deal with bad assets already in FSLIC's portfolio rather than those that are part of existing supervisory cases. The packaging option usually would not be available for these investments. Regarding the question of one subsidiary versus twelve, we believe that any decentralization benefits that would be achieved through a multiplicity of separate corporations also would be obtainable through the establishment of field offices under one organization, while using one corporation rather than twelve would be less expensive and would assure a greater degree of uniformity and control.

3) If a substantial amount of the Home Loan Banks' assets consisted of loans to the FSLIC, could this severely lessen the willingness of the private sector to invest in a Home Loan Bank's debt instruments? Why or why not? Currently what is the total excess debt capacity of the regional Home Loan Banks?

4) At what point would loans from the Home Loans Banks begin to impair the confidence of the private sector investors in the Home Loan Banks' debt obligations?

The willingness of investors to place funds in FLHBank obligations certainly depends upon their confidence in the financial strength of the FHLBank System, and it is possible that over-lending to the FSLIC and/or poor collateralization policies -- none of which are at all evident -- could adversely affect investor interest. It is not possible, however, to

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specify a particular bright line at which the extension of credit to the FSLIC would begin to impair confidence. Again, we do not seem to be remotely near any such point, nor does it appear likely that it would be approached in connection with any foreseeable program of credit extensions to either the FSLIC or the Section 406 Corporation. Concerning the excess debt capacity of the FHLBanks, we do not know what a reasonable approximation of that capacity would be, but we are confident that a considerable degree of surplusage remains.

5) The primary supervision of thrifts has already been delegated to the local Federal Home Loan Banks. If the disposition of problem institutions were also delegated to the local banks, what would be left for the Bank Board? Wouldn't there be a danger of the Bank Board losing control?

It is indeed vitally necessary that the FHLBB retain control over the responsibilities assigned it by Congress, and we are confident that the agency is in no sense using the 12 U.S.C 1437(a) delegation authorities extended by the Garn-St Germain Act to abdicate those responsibilities. With regard to the proposed Section 406 Corporation, we note that this subsidiary would be responsible only for disposing of bad assets already owned by FSLIC directly or held by it as receiver. It would have no role, to our knowledge, in the process of dealing with failing institutions.

6) Should the FSLIC require its insureds to make a one percent deposit in the fund? Why or why not?

Given the pressures on the FSLIC, there has been sentiment in some quarters favoring a recapitalization of its insurance fund. This is seen as a means of assuring that public confidence in federal deposit insurance will not be eroded by publicity over FSLIC expenditures, and of providing the agency with additional funds for its assistance activities.

As a practical matter, FSLIC-insured institutions already are participating in a FSLIC recapitalization thanks to the Bank Board's imposition this year of an additional insurance premium of 1/8 of 1% of deposits. Added to the normal 1/12 of 1% premium, this means premiums for 1985 will equal 5/24 of 1% of deposits; by contrast, commercial banks are supporting their fund a premium level of 2/24 of 1% of deposits, less any sums rebated. Rebates, it should be noted, are not a feature of the FSLIC premium structure.

Although the 1/8 of 1% supplemental premium will add approximately $1 billion to FSLIC's coffers this year, most

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persons advocating recapitalization envision providing the FSLIC with a far larger sum -- say $9 billion, or approximately 1% of total industry deposits. Naturally, considering concern over the federal deficit, apart from any other factor, these funds are seen as coming, not from the taxpayers, but from the industry.

Earlier this year, the League spent considerable time attempting to develop a recapitalization plan that would bolster the FSLIC and the public's confidence in it, while avoiding the need for additional supplementary premiums. For a variety of reasons, however, we determined to shelve our plan rather than to press for authorizing legislation. First, it was assumed that the funds infused through recapitalization could be carried by institutions as assets, as opposed to being expensed, as in the case of the special assessment premiums. Unfortunately, the informal feedback we received from the accounting profession in this regard was quite discouraging, suggesting that a significant portion of the approximately $9 billion we envisioned being assessed for recapitalization purposes might have to be expensed. The devastating effect such an action would have on industry profitability and net worth acted as an extremely powerful disincentive to further pursuit of the recapitalization option.

Another drawback to recapitalization was the opportunity cost involved. Inevitably, there would be a considerable gap between what the funds provided the FSLIC would earn compared to what they would yield if invested by the savings institution itself. This differential was regarded as a very significant negative factor by a great many of our members, who were extremely concerned about the need to put every available dollar to use in the most profitable manner in order to speed restructuring and the process of rebuilding capital. In effect, the feeling was that, on an overall basis, the system would be stronger if the dollars in question were left in the insured institutions rather than placed in the FSLIC.

A third basic reason for our retreat from recapitalization was our conviction that the problems of the FSLIC, though serious, were manageable within the context of the agency's existing resources and those that could be provided by the special assessment, provided that, as discussed in our testimony, new approaches to using these resources were put in place. Conversely, we were apprehensive that, without these new approaches, the substantial sums to be transferred under recapitalization would be managed in a less than optimal manner. Accordingly, we concluded that, under current circumstances, the most appropriate manner of dealing with FSLIC's financial situation was not the recapitalization route,

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with its accounting and opportunity cost problems, but that of seeking administrative -- and, where needed legislative -- steps to assure that the agency, in cooperation with the system it serves, was deploying its very considerable resources in the most effective manner.

7) If the FSLIC and the FDIC funds are not merged, where will the FSLIC obtain sufficient funds to deal with its problems over time?

As noted in our response to the preceding question, we believe that the problems of the FSLIC are manageable given the agency's existing resources and those that could be provided by the special assessment, provided that new approaches to using those resources -- such as the management consignment program, the Section 406 Corporation, and more focused supervisory policies employing new enforcement tools -- are put in place. Additionally, the various regulatory policies the Bank Board has implemented to protect the FSLIC -- direct investment rules, growth constraints and the like -- as well as the general improvement in the economic environment for our industry, are all contributing importantly to this manageability. Accordingly, we do not believe that the FSLIC currently is in need of any infusion of funds beyond what it is obtaining through the normal and supplementary premiums.

8) With regard to other forms of market discipline by uninsured depositors and general creditors, it is argued that the market discipline is fickle, is trendy. Indeed, it is argued that a run is the ultimate form of market discipline. How do you respond to these concerns?

The U.S. League does not in any sense regard "runs" as even remotely approximating an acceptable market discipline tool. They typically are based on ignorance, misinformation and panic, rather than an intelligent, dispassionate analysis of an institution's situation, and are very destabilizing for the system as a whole. Moreover, the onset of runs tends to be so whimsical and capricious as to nullify any possibility of their functioning in a market discipline capacity.

9) Should the FSLIC be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed bank with any profit after administrative costs arising from the transaction returned to the original stockholders?

10) If the burden of mismanagement was placed squarely and

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directly on the managers and stockholders, is it necessary to punish depositors and borrowers in order to achieve an improved supervisory system? If failures were handled through a purchase and assumption or forced merger at an earlier stage, regardless of size, wouldn't this dispose of the fairness question as it relates to large and small institutions?

For our general views on this point, please see page 36 of our formal statement. In terms of the fairness question, we are very aware of the need to deal with the too-big-to-fail phenomenon, but recognize that it would be very difficult to implement a fair and effective policy of formally requiring mergers prior to insolvency.

11) In your opinion, what are the advantages and disadvantages of risk-based capital and risk-based premiums? Should we consider one or the other or both?

For our views on this point, please see pages 13-15 of our formal statement.

12) There appears to be strong support for risk-based capital in some form. Some suggest an adoption of risk-based capital by the federal insurance agencies would give them the necessary authorities to regulate the activities of state-chartered institutions without granting the authority to override a state legislature. What is your view?

We agree that a regulatory agency by its approach to structuring risk-based capital requirements could extensively regulate the investments of state-chartered institutions. The posting of reserves is subject to manipulation, however, and a regulator might well feel more comfortable with a system that to some extent relied on a prohibition/exception regime, which would offer scope for individual review.

13) How would you recommend resolving the dilemma to the dual banking system created by states authorizing activities which place the federal insurance agencies at risk?

The U.S. League recognizes the benefits to the economy that the dual federal/state system of regulation of financial institutions has provided. Nevertheless, we have supported the imposition of reasonable restrictions on the activities of state-chartered institutions. Given the existence of federal deposit insurance, the legitimacy of the federal interest in the area cannot be denied. In terms of specific approaches, we believe that the deposit insurers should be able to restrict

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any activity that they determine to be an improper incident to the activities of an insured institution, but should approach the limitation process on a rifle-shot basis to avoid unnecessary interference with state-granted empowerments.

14) Do you believe that the FHLBB and/or FSLIC needs increased enforcement authority? If so, in what areas?

Our detailed views on this point are found in our formal statement at pages 20-22 and in Appendix A.

15) Does the Community Savings and Loan and EPIC problem reinforce the need for certain activities to be engaged through a subsidiary of the holding company rather than a subsidiary of a depository institution?

Any multi-company corporate structure involving a depository institution raises the possibility that the depository may be improperly utilized to support the activities of another part of the organization. Awareness of this has led to very strict statutory and regulatory limits regarding transactions between FSLIC-insured institutions and their subsidiaries and holding company affiliates. While we are not privy to the specific details of the Community/Epic situation, it does not appear that the transactions in question there would have been consistent with the legal framework that would have applied in the case of a FSLIC-insured organization, whether carried out at the holding company or subsidiary level. Accordingly, we do not believe that it would be appropriate, in the context of FSLIC-insured entities, to derive any conclusions from the Community/Epic situation regarding the superiority of requiring certain activities to be conducted at the holding company, rather than the subsidiary, level.

16) How can or should we determine if the size of the insurance fund is sufficient and will continue to be sufficient to assure confidence and manage the costs of potential failures?

There is no actuarial data that would allow us, or for that matter anyone else, to make a confident response regarding the amount of money the deposit insurers should have in order to manage the costs of potential failures. Given the linkage of risk in any systemic insurance structure, acturial concepts are hard to apply in this area. Looking simply at the public confidence question, the Congressional full faith and credit promise probably would permit maintenance of the insurance fund at a relatively low level, but it is not possible, of course, to divorce the question of confidence from the practical responsibilities that attach to the deposit insurance function.

17) Are there any provisions in the proposed tax legislation which would have an adverse effect on savings and loans? On potential savings and loan mergers? If so, please explain

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Our views on this point are found at pages 39-42 of our formal statement. We would stress again the severe impact of precipitate elimination of the special tax rules for thrift mergers.

Questions from Senator Proxmire

1) Mr. Pratt, the former chairman of the Federal Home Loan Bank Board, told us on July 25 that the "greater success of the FDIC as compared with the FSLIC has been simply a result of the fact that greater capital is required for banks as opposed to thrifts." He noted as well that in light of this "maybe variable capital requirements make more sense than variable risk premiums..." What do you think of this concept? What measure can we take to raise the capital requirements of FSLIC insured thrifts?

As noted in our testimony, we do not believe risk-based deposit insurance should be authorized on a permanent basis without first experimenting with variable net worth requirements. The advantage of variable net worth requirements, of course, is that they provide protection to the FSLIC without the same costs associated with deposit insurance premiums, which have to be expensed. Clearly, if we had to choose between a regime consisting purely of variable premiums and variable net worth requirements, the latter would be preferable. With regard to thrift capital requirements generally, we acknowledge the need to increase net worth, and note that the FHLBB/FSLIC already has taken important steps to improve the situation. Because the agency, as deposit insurer, has a great and direct stake in capital enhancement, it can be expected to continue to tighten capital standards at a pace consistent with the industry's financial condition.

2) One critique of risk based premiums is that weak thrift institutions would make even riskier loans in order to make up the cost of higher insurance premiums. Do you agree with this criticism?

We believe that the desperation "end game" strategy syndrome affecting some weak institutions is a genuine problem -- some managers irresponsibly will bet the (FSLIC-insured) company when in dire straits in the hope that a dramatic reversal of fortunes will occur. And it is possible that a risk-based premium structure that was sufficiently expensive might add enough to a weak institution's financial burden to contribute to any tendencies toward engaging in irresponsible investment strategies.

I hope these responses will be of value to you and your Committee in your oversight of the federal deposit insurance system. If I can be of further assistance, please feel free to call on me.

Sincerely,

Philip Gasteyer
Executive Vice President,
Director of Washington Operations

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DEPOSIT INSURANCE REFORM AND RELATED SUPERVISORY ISSUES

PART I

WEDNESDAY, SEPTEMBER 11, 1985

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, D'Amato, Gorton, Mattingly, Hecht, Proxmire, Cranston, Riegle, Dodd, Dixon, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

This is a continuation of the hearings this committee started in July on the reform of the deposit insurance funds. At this point we are still in the process of learning about the economic and business effects of the present deposit insurance system rather than considering any specific legislative proposals.

There are a number of differing ideas being raised as to the modifications that may be needed in the statutory structure.

Today we are pleased to welcome, obviously, a very significant force in determining the course of this body. We are pleased to have Chairman Volcker of the Federal Reserve with us today to testify.

Senator Proxmire, do you have an opening statement?

Senator PROXMIRE. I have no opening statement, Mr. Chairman.

The CHAIRMAN. Senator D'Amato.

STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Good morning, Mr. Chairman. I would like to welcome Chairman Volcker and thank him for attending today's hearing on deposit insurance reform. I am certain that his testimony will facilitate our examination of the adequacy of the deposit insurance funds.

Today's hearing is a continuation of a series of hearings discussing deposit insurance reform. We have heard from witnesses representing various sectors of the financial markets who have offered proposals designed to ensure the financial viability of the FDIC and FSLIC. These proposals would impose premiums upon banks and thrift institutions, increase the insurance fund, restrict acceptance

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of brokered deposits by banks and thrift institutions, merge the insurance funds or create a quasi-governmental agency to purchase troubled assets from the FSLIC.

Although we are still in the initial stages of our inquiry, it appears that none of the present proposals provide an adequate solution. For example, while the imposition of risk-related insurance premiums is an appealing concept, I am skeptical about the ability of regulations to accurately assess and assign the risk. Risk-related premiums may provide a short-term solution; but they also can have negative effects on those institutions that are considered riskier and perceived to be less sound than their competitors.

Increasing participants' payments into the insurance fund may ultimately prove necessary, however past implementation of the modified payoff approach has limited the erosion of the FDIC's insurance fund. Continued use of the modified payoff approach combined with increased supervision of banks may obviate the need for increasing the premiums insured institutions pay into the fund.

The imposition of restrictions on brokered deposits may not be the answer. Reliance upon brokered deposits becomes problematic where institutions pursue risky investment policies. Restricting brokered deposits may prove detrimental by compromising the real service brokers perform: namely increasing competition by financial institutions for funds, thus raising the returns small depositors receive.

Others have suggested that the insurance funds should be merged. It became readily apparent from the testimony received yesterday that this proposal will not curb the erosion of FSLIC's funds since the cause of this erosion has resulted from ill-advised investment practices. The merging of insurance funds does not address this problem. The thrift crisis must be addressed directly.

Other alternatives such as the creation of a quasigovernmental agency to purchase assets from FSLIC have been suggested, and deserve further examination. While considering the proposals before the committee, we must remember that our decisions on this issue should be guided by the concept that deposit insurance is not meant to protect banks from failure. Rather, deposit insurance is designed to foster confidence in our banking system by guaranteeing the deposits of the average American.

While reform may be necessary, we must be sure that reform restores the viability of the Federal Deposit Insurance System rather than creates uncertainties in the marketplace. I look forward to the testimony of Chairman Volcker and appreciate his efforts in assisting the committee's examination of the Federal Deposit Insurance System.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Dixon.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I would like to begin this morning by congratulating you for your leadership in this area and for bringing the deposit insurance issues before the committee for review. This is the fifth in our series of hearings on deposit insur-

ance reform and related supervisory issues and I appreciate the time and attention you have devoted to this matter.

I share your view that committee oversight and consideration of these issues was overdue and I look forward to working with you in crafting such appropriate and reasonable legislation as may be necessary after the committee's hearings are concluded. I would like to express the hope, however, that the committee will also see fit to act in the near future on a number of other very pressing agenda items. For example, the thrift industry Net Worth Certificate Program and the Federal regulators emergency acquisition authority will soon expire. I think it is imperative that we act on those issues quickly.

I also hope we will turn our attention to the problems facing agricultural banks and other financial institutions serving agriculture. While our overall banking system is in good general health, banks and others serving the rural economy are facing a crisis larger than any since the Great Depression. We need to act to provide appropriate help for those institutions and their farmer borrowers. If we do not act, a major portion of America's farm families will be forced off their land.

Finally, I believe it is long past time to act on the comprehensive banking legislation this committee reported last year. This legislation passed the Senate by an overwhelming margin last year, and the conditions that caused the committee to act on the bill have not changed. Indeed, the need for the committee to act may be greater now than it was then.

The issue before the committee this morning, however, is deposit insurance. I look forward to the testimony of the distinguished Chairman of the Federal Reserve Board, Paul Volcker.

The CHAIRMAN. Mr. Chairman, it's all yours.

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Thank you, Mr. Chairman. You have embarked upon a large subject here and, among other things, asked me to touch upon a number of points in my statement today, and I will simply proceed to read it.

[The complete prepared statement follows:]

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Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

I appreciate the opportunity to be here today to comment on proposals for reforming the Federal deposit insurance system and to review some other elements of the appropriate federal approach toward depository institutions.

In the light of recent and current problems in banking and thrift institutions, such a review is natural. At the same time, as proposals for changing deposit insurance and supervisory arrangements for depository institutions are reviewed, we should not lose sight of their successes, both in the past and in coping with the present strains.

For many years, the number of failed depository institutions was miniscule relative to the number of such businesses. Recently, there has been a significant increase in actual or near failures, and the financial system as a whole has been under greater strain. But the points of particular pressure have been dealt with in a manner that has avoided contagious chain reactions, and the health of other financial institutions and the economy has not been undermined. As intended by the Congress, no small depositor

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of any federally insured institution has lost money because of a bank failure, and losses to larger depositors and other creditors of banking organizations have been very limited, without calling upon support of the general taxpayer.

As we review this experience, it is also natural and appropriate that you consider whether improvements need to be made in the functioning of our deposit insurance and supervisory systems. We have indeed seen a number of organizations, including some larger ones, fail or be forced into merger or reorganization in the past few years. And, while that number has remained comparatively small, the reports of our federal and state examiners reveal that a sizable number of additional institutions have serious problems. Considerations of how to deal with these problems and, indeed, how to turn around the recent trends, are thus in order.

In part these problems are traceable to the heightened degree of competition to which institutions are now subject,

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a development fostered in large part by technological and financial innovations both at home and abroad. Those innovations, in turn, have been accompanied by, and in good part forced, greatly relaxed regulation of interest rates paid on deposits. Some institutions have importantly expanded asset powers.

The economic environment has also changed in a way that has increased the risks in highly aggressive banking practices. That change was punctuated by a major recession in the early 1980s, which itself strained the finances of many businesses and individuals. But we also had a vigorous recovery and expansion, and ordinarily credit quality would be expected to show marked improvement after the first year or so of recovery. That has not happened so far during the current expansion.

In significant part, that is because the nation has also been going through the more fundamental process of moving from a condition of accelerating and anticipated inflation to one of much more moderate price pressures generally. In fact, downward price pressures in some previously inflated sectors of the economy

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have been evident, and real interest rates have been unusually high. Many ventures thought likely to be profitable by financial institutions and their customers during an inflationary period have turned out not to be so. The energy, shipping, agricultural, and real estate areas are replete with examples.

Moreover, patterns of thinking shaped during inflationary times are hard to dispel. Thus, some projects undertaken by entrepreneurs and financed by depository institutions--and sometimes those roles are combined--still seem to depend importantly for their success on increased prices, particularly with respect to some kinds of real estate development.

The strength of the dollar in international currency markets has also been a factor adding to pressures on the manufacturing, mining, and agricultural sectors, even as the economy as a whole has grown substantially. A number of important foreign borrowers in Latin America and elsewhere, who were favored lending outlets during the highly inflationary

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period, have found themselves in an over-extended position in the current economic climate.

I believe a third major source of our current problems can be traced to certain changes in banking and public attitudes that emerged gradually as memories of earlier difficulties faded from consciousness and the postwar economy and financial markets displayed remarkable--indeed virtually unprecedented--growth and stability. Banks ended World War II with unusually high liquidity and strong capital positions. It was natural and healthy that these funds would be more actively employed over time, and that the extreme caution bred by depression would be dissipated. In the absence of signs of real difficulty for several decades, a new generation of managers, directors and regulators, basing their judgments on postwar experience, shifted the focus of bank policies away from concerns with safety and toward greater risk-taking in a quest for larger profits in a highly competitive environment. In time, and further induced by the inflationary

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expectations bred in the 1970s, these tendencies were carried beyond prudent limits in a few institutions.

These risks have been aggravated more recently by reactions of some managers, particularly in the thrift industry, to a prolonged period of extreme earnings pressures in their traditional lines of business. Implicitly or explicitly, they decided, in effect, to "roll the dice" by undertaking particularly risky activities generating immediate profits or the hope for large gains over time. From the standpoint of managers or owners, the chance of failure of the institution was already large, and should sizable losses rather than gains materialize, depositors would, in any event, in whole or in part, be protected by deposit insurance.

One general question before you is the extent to which these changes in attitude and behavior have been inadvertently encouraged by the federal "safety net"--indeed the extent to which the very

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success of those arrangements, in protecting individual depositors and the financial and economic stability generally, has also encouraged some depository organizations to assume inordinate risks for both the institutions and the insurance system.

One aspect of the dilemma for the authorities is that institutions may, consciously or unconsciously, build into their decision-making the view that deposit insurance and the availability of discount window credit will give added time and leeway to deal with unforeseen problem situations that may arise, thus making institutions less self reliant and less concerned about risk despite the vulnerability of equity owners. Depositors and creditors of banking organizations themselves, because of the safety net, may anticipate that the "government," in the last analysis, will take actions to protect them against loss, so they can be relatively indifferent to the risk exposure of depository institutions. That is obviously the case for insured depositors who, by design, rely on the federal insurance backing their deposits rather than on the financial health of their banking institution for the return of their money.

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The other side of the dilemma is that the "safety net" provides an essential public service, not only in protecting small depositors, but also in avoiding spreading fear among depositors generally, thus undermining the stability of the system as a whole. Instilling discipline at the expense of a financial debacle would be a pyrrhic victory.

Clearly, part of the challenge is to maintain a strong and effective safety net while minimizing adverse side effects on excessive risk taking. One important means of maintaining such balance is that management and owners of failed and distressed institutions are not, and should not, be immunized from the consequences of bad decision-making and excessive risktaking. Stockholders lose when a bank has failed or gotten into trouble; management has lost jobs and reputations. Moreover, recent events confirm that uninsured depositors and creditors do not feel entirely free of potential risk, and some recent events have alerted managements to the importance of maintaining confidence.

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There is one aberrant situation that has been of strong and understandable concern to the insuring agencies. I touched earlier on the apparent temptation of some thrift institutions, finding themselves with negative earnings and impaired capital and concerned about their ability to restore profitability through adherence to normal business practices, to channel funds into risky financial ventures. In some cases, these practices are directly aided and abetted by the fact that the institution is able to obtain more sizable funds than would otherwise be possible by issuing insured deposits at relatively high rates, quite often through the auspices of a broker. Such insured deposits have been highly attractive because they have provided interest returns above the general market level, and because they are fully insured and free of risk regardless of the condition and activities of the issuing institution. Given this potential for abuse, we have supported the concept of strict limitations on certain insured-deposit brokerage activities.

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In sum, the burden of my remarks is that the insurance system, the safety net, and the processes of banking supervision, faced with the strongest challenge in decades, have functioned with remarkable effectiveness to protect the stability of the banking system. We must not impair that effectiveness. At the same time, we want to learn all that we can from recent experience to encourage a still stronger, self-reliant system, to deal with the sources of strain, and to speed a return to a situation in which active use of the safety net is reduced. In that process, we want to build on the existing strengths of the system, and to encourage the efforts already strongly underway among many depository institutions to improve their own positions. Perhaps it is also worth emphasizing that this is no time for overreaction--for encouraging the pendulum of attitudes and policies by either managements or officials to swing to the point that reasonable innovation, risk-taking, and growth is stifled by unwarranted fear and uncertainty.

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Market Discipline

One approach toward maintaining a balance between stability and risk-taking would involve reinforcing, or duplicating by other means, disciplines inherent in the market process. Ideas along this line run from more frequent disclosure of information about the condition of banking and thrift institutions to increasing the frequency and the certainty of loss that large depositors and other creditors would suffer in the event of failed institutions. The concept is that, by intensifying the consequences of bad decision-making, depository institutions--their managements, directors, shareholders and depositors and creditors--will be more sensitive to risk, promoting safer and sounder practices.

Obviously, sensitivity of depository institutions and their customers to the consequences of risk-taking is fundamental to prudent banking. Any manager blinded to that fact by years of tranquility has been forcibly reminded by recent events. But our financial history demonstrates unambiguously the dangers of relying on market discipline alone. Prior to the 1930s, market

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discipline did not prevent bank failures or systematically discourage excessive risk-taking--until after periodic crises had occurred, at great expense to the economy generally. Indeed, the entire rationale for the establishment of the Federal Reserve and the FDIC lay in the realization that institutions at the core of our payments and financial systems have a unique importance for the stability of the economy generally.

Recent years have seen considerably more public disclosure of loan concentrations and other matters. Normally, the presumption should be in favor of wide disclosure in the interest of full market information to investors, within limits imposed by customer or competitive confidentiality. But such disclosure provides limited protection at best against imprudent lending or other risks, which are usually not apparent in simple listings of concentrations and which, indeed, often are exposed after the fact.

The question remains of striking an appropriate balance. Experience suggests strongly that creditors and investors find

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it difficult or impossible in practice to make reliable incremental appraisals of the degree to which institutions are taking excessive risks prior to the time the consequences of such activities become readily apparent. To take one example, the Continental Illinois Bank was an investment favorite, praised for aggressive expansion, virtually until the eve of the exposure of massive problems in its loan portfolio. Those problems were initially centered in the energy area. But aggressive energy lending, in the environment of the 1970s and early 1980s, was considered appropriate and desirable in the marketplace for many banks, and those banks were generally characterized by high earnings, stock prices, and growth. Investors and depositors detected and reacted to the problems only <u>after</u> it was clear that a highly aggressive lending posture in the energy area had yielded bitter fruit. Then left untempered, the reactions would have been so strong as to undermine a number of banks' prospects for viability, with widespread secondary repercussions. A similar pattern of years of complacency, even when the general nature and size of

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the lending is well known, could be cited in the growing loan exposures of multinational banks to developing countries. Similarly, the exposure of thousands of small agriculturally oriented banks is today viewed very differently than only a few years ago.

In other words, in an inherently uncertain world, subject to changes in objective circumstances and fashion, the prescience of market forces is necessarily limited and sentiment quickly reversible. Once it becomes reasonably clear that an institution has difficulties, sharp swings in attitude can undercut orderly solutions, posing risks to other banks and the financial system in general.

There is no doubt that market forces ultimately are capable of, and do, impose a severe discipline. We want to take advantage of that. But we would also like those disciplines, to the extent feasible, to work consistent with constructive solutions to problems, which takes time, rather than to exact its lesson at the expense of economic stability generally.

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In striking that balance, the Federal Reserve has not favored proposals that would have the federal agencies themselves, as a general rule, disclose detailed cease and desist orders or other disciplinary action they have issued against banking organizations. Such routine disclosure may at times exacerbate an already delicate situation and make more difficult the task of federal regulators seeking an orderly and appropriate resolution of problems that are, in fact, "curable." Larger banking organizations with widespread public ownership are already required to disclose material changes in circumstances, including the official enforcement orders bearing on their outlook. There are situations in which detailed disclosure by a banking agency itself might serve a useful or necessary purpose, particularly when the management is not actively and wholeheartedly moving to deal with its problems. But that is not ordinarily the case. Rather, the entire procedure will often become more, and unnecessarily, adversarial, making it more difficult for examiners to obtain

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information or engage in a frank exchange of views, and tying up limited supervisory and enforcement manpower in legal proceedings.

Risk Based Insurance

One proposal that has been set forth, as a kind of substitute for direct market discipline, to achieve greater control over risk-taking by depository institutions--and also to make the depository insurance system more equitable--is to shift from the present flat-rate deposit insurance premium system to a risk-based system. In concept, institutions taking a significantly riskier position would be required to pay higher premiums than conservatively managed organizations.

In principle, the proposal appears logical and attractive. It seems undeniably fair to require those institutions exposing the insurance fund to greater risk to pay higher premiums to compensate for that risk, an approach long followed by private companies in all areas of insurance.

But there is reason to question the practical benefits of such an approach. If differential insurance premiums are to

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effectively deter excessive risk-taking, the range between premiums charged institutions exposed to relatively great risk and those operating more conservatively would have to be fairly wide. But such a wide range for premiums implies more precision in gauging the risk exposure of different institutions or different types of lending than may be objectively possible, or that is widely perceived as fair. We don't, for instance, want to indiscrimately place a drag on commercial lending, or agricultural lending, or energy lending. The size of the insurance premiums might be interpreted as a kind of credit rating, but it would be too crude to bear that burden. And I don't see, in practice, how the premiums could be "fine-tuned" before problems in fact emerge.

It may be possible, for instance, to get general agreement as to the relative riskiness of broad categories of balance sheet positions. All would agree, for example, that private loans are more risky than Treasury securities; that a low liquid asset ratio, particularly if accompanied by heavy reliance on purchased money,

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is more risky than a high ratio; that a marked imbalance between asset and liability maturities is more risky than a close balance. But once past those relatively broad concepts, consensus becomes much more difficult to achieve.

There are many less tangible factors--such as the quality of an institution's management, its internal controls, and its credit standards whatever the lending area--that affect the riskiness of an operation and should be taken into account. The principal differences in the quality and relative riskiness of loan portfolios lies within broad loan categories, as much or more than between them.

Bank examiners, of course, make such judgments. But there would be great drawbacks to basing premiums on the already difficult, and inherently qualitative, judgments contained in bank examinations. Such judgments are fallible and our forecasting ability is limited. To reflect those judgments routinely in large changes in insurance premiums, involving both public notice and higher costs, could well diminish prospects for effective remedial action.

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Some have suggested the problems inherent in ex ante identification of risk could be dealt with by levying premiums on an ex post basis--that is, to charge institutions experiencing losses higher premiums. But does it really make sense to levy punitive premiums under such conditions, placing an added drain on the earnings of an institution with substantial problems, and, in effect, announcing that added burden to the world? Rather, would it not often work at cross purposes with the efforts that federal regulators would be making at such times to restore the institution to health?

I recognize that, even if the possibility of using sharply differentiated insurance premiums as an effective deterrent to excessive risk is limited, some distinctions based upon the general characteristics of a bank or thrift may appear more equitable in terms of relative contributions to the insurance funds. Moreover, there may be certain types of loan and investment situations which are clearly so risky relative to the "norm" that a sharply higher insurance premium could be clearly justified.

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That might be the case, for example, with real estate development activities of the kind that some institutions are actively developing, as permitted by some states. But I would have to question, if the risks are so evident, whether such activities are appropriate for depository institutions at all.

As I have emphasized to this Committee before in this connection, I am deeply concerned about the increasing tendency of states to provide powers for state-chartered institutions operating under the protection of the federal safety net that may be inconsistent with prudent banking or thrift operations. That, indeed, seems to me an area where action is urgently needed.

Other Reforms in Deposit Insurance

I should like to comment briefly on several other proposals for reforming the deposit insurance system that have been advanced in recent years. One such proposal is to move the deposit insurance limit back down to a significantly lower level. It is reasoned that this will result in a larger proportion of deposits being subject to loss should an institution fail, and, by increasing

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risk exposure, encourage depositors to be more selective in placing their funds with institutions.

The precise level for assured insurance protection is, of course, arbitrary, and I have myself resisted the large increases enacted in the past. But we are not dealing with a blank sheet of paper. Depositors and financial markets generally are accustomed to, and presume maintenance of, the present $100,000 level.

It seems likely that if insurance coverage were reduced somewhat, the main effect would be that most smaller depositors with amounts to place that exceed the cutoff would simply channel them into two or more deposit accounts with different institutions. Accordingly, costs to depositors and the banking system would be raised. If the insurance level were to be sharply lowered, the proportion of "runable" deposits at all institutions would increase, increasing the potential instabilities of the system at a time of strain.

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In concept, looking further into the future, there may be some merit to increasing, in a careful and limited way, the effective risk exposure of larger depositors, inducing them to make a more careful assessment of the conditions of organizations in which they are placing funds, and working in a marginal way to encourage more prudent banking practices. But those depositors are not entirely without risk today, and I do not believe this is the time to inject more uncertainty into the system. Any changes in this respect should be made, in my judgment, only in more settled circumstances, and with long lead times.

I believe a fair description of the present approach in operating the "safety net" is to provide full protection for depositors within the insurance limits but also to protect all depositors when that is practically feasible at reasonable cost through mergers or otherwise, taking account of the costs of alternatives, including the effects on the community and banking stability more generally. The number of cases in which that

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protection has not been possible and feasible in practice has been very small, for banks large or small. That approach seems to me to remain broadly appropriate. It does not commit the FDIC or the FSLIC to full protection in every circumstance--such as when some combination of huge potential losses, unknown contingent liabilities, and possibilities of fraud could clearly impose excessive costs relative to practical alternatives. In a few cases, a full payout to insured depositors alone has been necessary.

As the Committee knows, there has been some testing by the FDIC of a modified payoff technique. This technique involves deriving an estimate of the proportionate amounts of the uninsured depositor claims that are likely to be recovered from the liquidation of a closed institution's assets and then paying that amount to the depositor immediately rather than waiting until the liquidation is completed. Any recovery above that minimum is to be passed through after it is realized. That approach, I believe, could be an improvement over the delayed payoff approach that is routine in general bankruptcy proceedings, since it helps reduce

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the side effects of uncertainty and reduced liquidity to which depositors are otherwise exposed. But I do not envisage such an approach as a satisfactory substitute for the so-called "purchase and assumption" technique or other forms of assistance when those alternatives are feasible and costs reasonable.

In considering that or other new approaches, careful consideration must be given to the uncertainties inherent in change at a particularly sensitive time. In that spirit, proposals that might partially insure larger depositors, but at the same time increase the risk of loss or illiquidity of an uninsured fraction, could be debated. But any change in that respect should be announced far in advance, and implemented with great care.

Proposals to require institutions to pay the same premiums on their deposit liabilities at overseas branches, and at International Banking Facilities, as they do on all other deposits booked in the U.S., deserve careful review. These depositors benefit from the greater stability of financial conditions that result from the deposit insurance system as much as do other large depositors.

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Thus, it seems fair that banking organizations choosing to fund part of their operations overseas--and that proportion can be "managed"--should be subject to the same insurance costs as those that rely on domestic sources of funds.

At the same time, extending insurance costs to foreign branch deposits changes the relative cost burdens among our depository institutions, affects incentives to branch abroad, and raises some competitive questions vis-a-vis banks abroad. A fuller assessment of the pros and cons appears to me in order before proceeding definitively, and if a decision is made to implement the proposal, it should probably be phased-in over a period of years.

Proposals also have been advanced for merging the FDIC and FSLIC insurance funds. In principle, this would appear appropriate if and as these depository institutions are required to adhere to equivalent regulatory and supervisory standards, and particularly if their powers broadly coincide. There has been

some movement in those directions, but there also remains a good ways to go.

Whether one would want to proceed more immediately to merge the funds would appear to depend on how the advantages are weighed, in current circumstances, of bringing the larger resources of the FDIC fund to the support of the savings and loan industry. Against that advantage there is a legitimate question as to whether monies contributed by commercial banks and mutual savings banks should now be made available to protect the depositors of savings and loan associations. At the least, the importance of bringing the regulatory and supervisory standards of the two industries into alignment promptly would be greatly reinforced. But, in addition, I believe the Congress, in addressing such a proposal, should consider possible means for bolstering the size of the FSLIC fund or the relative contribution of the savings and loan industry should it decide to authorize such a merger.

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Other Initiatives

Apart from the initiatives in the deposit insurance area I have just reviewed, I believe there are other actions--indeed more important actions--that are being taken and that can be taken to strengthen further our depository system and achieve greater assurance that it will continue to function safely and efficiently.

Federal insurance and other elements of the federal "safety net" necessarily imply a clear federal interest in how the protected funds are employed and managed. To some degree, strong supervision can minimize the need for, and demands upon, the "safety net." And no insuror can afford to be indifferent to the behavior of the insured.

All the federal agencies, individually and in cooperation, have taken steps to strengthen the supervisory and, where necessary, the regulatory process. I can speak directly here only of the Federal Reserve, where a number of steps are underway to implement a comprehensive program for further strengthening our supervisory and regulatory activities.

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As you may recall, in conjunction with the other bank regulatory agencies, we have over the past few years tightened significantly our capital standards applicable to banks and bank holding companies. These standards were first put in place on a formal basis in the early 1980s and have helped to reverse the earlier downtrend in capital asset ratios.

We now have under active review, as do the other federal bank supervisors, proposals for supplementing the existing standards. One objective is to take account of the rapid growth in "off-balance sheet" risk exposures and declines in liquidity, particularly at larger banking organizations. To some degree, the simple capital/asset ratios that are at the center of our current guidelines contribute to those developments; institutions work to improve those ratios by holding down asset growth partly by limiting liquid asset holdings and by assuming off-balance sheet commitments in lieu of direct lending.

We can and are approaching the problem in part through strengthening the crucial process of examination, emphasizing that

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existing standards are minimums that can and should be exceeded depending upon the risk profile of an institution. We are also carefully considering several variants of proposals for quantifying a risk-related capital measure to supplement the present approach. I anticipate that one or more approaches will be set out for public comment before the end of the year.

In adopting such an approach, we face some of the same difficulties that I outlined in connection with risk-based deposit insurance, particularly the difficulty of assigning appropriate weights to different broad asset categories. But these standards potentially can be applied, and bank performance monitored, in the context of a detailed examination process, and the approach has the further potential advantage of contributing to international comparability.

The Chairman of the FDIC has proposed phasing-in an increase in the minimum capital requirement for banks to 9 percent, permitting the increase to be in the form of subordinated debt. That is another initiative that I find attractive in concept and worthy of study.

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The idea is that market discipline would be reinforced at the margin without further jeopardizing depositors--indeed, consistent with stronger depositor protections--by requiring banks to find a larger market for debt (or equity) that would have no insurance protection. At least as important in my view, the added capital would provide an extra cushion of protection against the possibility of loss to depositors and the deposit insurance fund.

The Federal Reserve also has under active review other proposals for modifying the structure of regulations and guidelines in place to see that banking organizations meet appropriate standards in conducting their business activities. Specifically, we are preparing standards to guide a bank holding company with respect to appropriate policies toward cutting or eliminating the payment of dividends when and if the organization is experiencing significant problems. We are also actively considering, within our present authority, appropriate limitations on bank holding companies undertaking particularly risky activities that may be

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sanctioned by state law but which appear to extend beyond the intent and framework of federal legislation.

Meanwhile, we have underway a number of significant steps to enhance our ability to identify, and seek correction of, problem situations at individual banking organizations. The frequency and intensity of examinations and inspections of larger banking organizations is being increased, while at the same time we seek to increase cooperation and coordination in the examination of smaller organizations with other federal agencies and state banking authorities. Indeed, if states are willing and have the required resources, we would plan to increase our reliance on their examinations of smaller banking organizations.

Communications with the boards of directors of large organizations with problems are being upgraded in content and official participation. Where warranted, we will make full use of our statutory powers to see that banking organizations cease activities that are causing them harm and adopt policies that will restore their financial health.

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Conclusion

At a time in which domestic and world economies are subject to many imbalances and distortions, banking systems here and abroad have been burdened more heavily than in many years, and we have seen some unaccustomed failures and reliance on the "safety net." That alone justifies a review of steps to ensure that our banking institutions, and their supervisory agencies, are following policies and practices consistent with the earliest possible return to robust health and full self-reliance.

But in making that review, let us not overlook the many continuing elements of strength in the banking system that enable it to deal with points of pressure. The vast majority of our depository institutions have absorbed and adjusted to a less favorable financial and economic environment in a way that retains, and even reinforces their resiliency. Capital ratios are improving, profitability has generally been maintained, well-run thrift institutions, at present interest rates, have the potential for rebuilding capital, and I sense managements of most

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institutions have acted to review lending standards and control systems. It is these factors that support confidence and prospects for the future. At the same time, the "safety net" has operated with great effectiveness; it has done what it is supposed to do and what the American public has expected. It will continue to do so.

The issues you are reviewing are as complex as they are important. There is a need to proceed--but to proceed with all due caution--so that any changes will in fact contribute to reinforcing solutions to our current difficulties and to a stronger banking system, not the reverse. I have indicated that the Federal Reserve has been moving to improve its regulatory standards and strengthen its supervisory capabilities. As you know, the other federal agencies responsible for supervising depository institutions are taking steps.

Our problems have been manageable. They should remain so. We welcome the cooperation of the Congress in that effort, not simply with respect to the questions under review today, but more importantly and fundamentally in dealing with the underlying sources of the imbalances and distortions in our economy and financial system.

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The CHAIRMAN. Thank you, Mr. Chairman.

As you know, we started these hearings in July. We started with Chairman Isaac of the FDIC and I'd like to summarize some of his testimony and get your response to it.

FDIC IS LENDER OF LAST RESORT

First of all, he said that it is a misnomer to call the Federal Reserve Board the lender of last resort. Since all Fed loans are fully collateralized, the FDIC is the only lender at risk and therefore the true lender of last resort.

He suggested two reforms: One, direct or authorize the Fed to make unsecured loans through the discount window; or the Federal Reserve should be directed to obtain a certificate from the primary supervisor stating the institution is solvent, and the extension of credit would be in the public interest.

He claims that the way the Fed operates now it merely serves to increase a run at the expense of the FDIC. In Continental, for example, the Fed lent $9 to $10 billion but obtained $20 billion in collateral. Consequently, unsecured and uninsured lenders are more inclined to run. Instead of providing confidence, they increase the run. Additionally, it is most unfair to the FDIC since the Fed has replaced an unsecured creditor with a secured creditor.

How do you respond to Chairman Isaac's comments?

Mr. VOLCKER. I'm not really sure of the purposes Chairman Isaac had in mind in raising that question, but I can give you a reaction.

I think there's a certain division of labor here or a responsibility that has been understood. It can obviously be changed. We have, I think, since the start of the System been thought to lend on a secured basis—without arguing technically how much collateral you need and all the rest. We have been looked to as a lender of last resort to lend freely to institutions having liquidity needs, when we can do that with rather minimal risks.

Now, indeed, you can have one of these situations where some question of credit standing or solvency arises, as well as liquidity, and when there's an important situation these questions are always somewhat mixed. We typically and always lend on a secured basis. You have to respond to these situations quickly and we do so.

If we lent on an unsecured basis, then we're put in a different position. We're in some risk of loss, which is all right with me as long as you understand that; that the Federal Reserve would then be in a position that it would take losses; and we would take losses in some instances because it would be inevitable at times in those circumstances. We're going to do our job of providing an ample amount of liquidity, and you get mixed situations.

I think we then ought to have the authority to be reimbursed appropriately for those losses which would mean such things as the power to take an equity interest in the bank, which the FDIC has, and under those conditions I think we could proceed.

But I would point out that then I don't think you have much need for the FDIC anymore. We would be taking over their function as provider of capital as well as liquidity, and I don't think that's what you've had in mind. I think the present division of

labor works reasonably satisfactorily so long as there's cooperation and coordination between the agencies. I would agree—if this is the thrust of Mr. Isaac's remarks—that when we get in these situations where we are lending to an institution where the question of possible FDIC assistance down the road or more immediately is raised, that should be done with full knowledge on both sides and full consultation and full cooperation. I think that is our intent and that has been the typical picture.

The CHAIRMAN. Well, how would you respond to specific suggestions that the Fed either make unsecured loans or obtain a certificate from the primary supervisor if the institution was insolvent and that then a secured loan would be in the public interest?

Mr. VOLCKER. I don't think it's very appropriate to have a kind of bureaucratic running around to get a certificate. I think this should be with consultation, over time. I suppose the object of that is to put Mr. Isaac in charge of the Federal Reserve, and I'm not going to agree to that.

The CHAIRMAN. Well, if the FDIC is the institution at risk, though, and the lender of last resort, shouldn't they have more control over the process?

Mr. VOLCKER. More control over——

The CHAIRMAN. Over the process, over the whole process?

Mr. VOLCKER. I think they have adequate control and influence now. They have a lot.

The CHAIRMAN. Well, the point is——

Mr. VOLCKER. I don't think they're the lender of last resort. I'm not sure the FDIC has ample funds for that; we lent Continental $8 to $10 billion, whatever the number was. This lending might have taxed the resources of the FDIC.

The CHAIRMAN. Well, the point he's making, if you have only secured loans and essentially nothing at risk, you are not the lender of last resort; they are because they are the ones that are placing their funds at risk.

Mr. VOLCKER. They are the capital providers. I think they have been assigned the position of taking the risk—the insolvency risk. That's what's been understood. Now if you want to give us that, OK. But I think you ought to understand that.

The CHAIRMAN. In your statement you advise the committee not to overlook the many strong elements and strength in the banking system. I've made that comment over and over and over again, that overall it is very strong, and we do tend to look at the weak points. And yet, I don't think anybody disputes that the climate has changed rather dramatically. We are in a much more difficult period than we have been for a long time.

Your statement covered a lot of ground, a good deal of general ground. Most of the other witnesses have made some very specific recommendations.

What specific recommendations do you have for changing the insurance funds to make them stronger and provide more confidence in the system?

Mr. VOLCKER. Let me, in answering that question, say the most important recommendations I would make to the Congress right now are not in this area.

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REDUCE THE DEFICIT

The CHAIRMAN. Well, I agree the deficit needs to be controlled.

Mr. VOLCKER. I would want to emphasize that.

I don't see that you face urgent problems in the performance of the insurance fund or the safety net generally. As I sit and look at recent experience, I think it's operated pretty well.

The CHAIRMAN. Well, I would agree, Mr. Chairman, but what we're trying to do—and I can't control the whole Senate of the Congress of the United States on the deficit. I only have 1 vote out there out of 100.

Mr. VOLCKER. I agree with you that's No. 1, but if I worried about the health of the financial system, I would say what is going on now and which is demonstrated—we read about it in the papers every day—are the risks being taken, the manipulations being undertaken by some financial institutions under extended powers by State authorities. If I wanted to deal with a growing rot in the system, I would deal with that first of all. I don't see how you can evade that.

It's going on and it's going on in increasing amounts. The examples are evident to everybody. The taxpayers in Ohio and Maryland are paying the costs rather directly, but it's going on increasingly within the Federal system. It ought to be dealt with.

We ought to deal with this nonbank bank question, which is putting strains on the system. We ought to deal with the related nonthrift thrift problems.

You're going to have to deal with the extension of net worth certificates. You're going to have to deal with the extension of emergency acquisitions over State lines, and I would recommend some limited liberalization of that program.

I think those are more urgent than rather theoretical considerations about precisely how the insurance system ought to be reformed.

The CHAIRMAN. Mr. Chairman, we passed a bill in some of those areas 89 to 5, yet we couldn't get the House to do anything last year, So, I could not agree with you more. I have felt those problems have been urgent for years and I have been doing everything within my power to move under great criticism at times. But at this time I'm faced——

Mr. VOLCKER. You certainly have frustrations.

The CHAIRMAN. I'm faced with great frustration in attempting to get Congress to look ahead for once. Now you just made a comment that said that the change in the deposit system is not urgent. I would agree with that. There is no crisis that we have to act next week or next month. But you know as well as I do, you've been around this town long enough to know that we normally wait until something is urgent and there is a crisis before we act.

So that is why I am pressing everybody for some specific answers for once to try and look to the future and try and revise the Federal Deposit Insurance System now while it is not urgent. So that at some future time I'm not being beseiged by people saying, "Why didn't you do something back in 1985 when you had a chance?" Maybe it's 1988 or 1989. That's what these hearings are all about, grasping for once for the future, recognizing that we have some se-

rious problems, not urgent in terms of 1 week, or 1 month, or 2 months, but trying to get Congress once to act in the future or looking to the future, making some long-range plans rather than always responding after the horse has left the barn, or Chicago has burned down, or whatever.

That's what I'm driving at and why I'm pressing you so hard, the Fed, the primary regulator in this system. What steps do we take so that long after you and I are gone somebody maybe looks back and says, "Hey, those people did a good job back in 1985 and 1986 and prevented us from having some serious problems in the deposit insurance system."

Mr. VOLCKER. You put me in a dilemma in one respect.

The CHAIRMAN. I'm trying to put you in a dilemma.

Mr. VOLCKER. Let me explain the dilemma or repeat the dilemma once again. There are some steps you can take. This question of premiums on foreign branch deposits raises some competitive problems. You may want to phase it in, but it's a perfectly straight forward equitable kind of proposal. It's not going to change dramatically, in any way, the general characteristics of the system.

You could introduce—and it may make some equitable sense—at least the authority for some limited risk-based premiums. We already have the authority for a risk-based capital requirement which may be more promising, although it has some of the same problems. We intend to proceed in that area.

When you get into more fundamental reforms of the system, of the type you may be alluding to—changing insurance limits, forcing some losses on uninsured depositors, that kind of thing—I would say you should only be looking at those kinds of things—and they are relevant—for phasing-in way off in the future, because you're changing the presumptions upon which people are operating. Therefore, you can think about them but I wouldn't enact them, now because I think they are the kind of things that should be looked at for very slow phasing-in over a period of time and not something to be introduced when the system is subject to an unusual amount of uncertainty at the moment, even assuming those things aren't changed.

The CHAIRMAN. Well, I would say in response to that statement that you have picked the area where Congress does its best work—very slowly. We are very good at taking years to do things, so I don't think you have any great worry about dramatic sudden changes that will take place in either this body or the House of Representatives.

My time is up on this round. Senator Proxmire.

Senator PROXMIRE. Chairman Volcker, we are all aware and, of course, you are the expert on this, of the great importance of the Federal Reserve and the Federal Reserve's policies and particularly at a time when we have the kind of serious difficulty with our fiscal policy that we have with the enormous debt.

VACANCIES ON THE BOARD

We all know that the vacancies are now occurring at the Federal Reserve Board. The President has made two appointments—Martha Seager and Preston Martin. Mr. Gramley is leaving and

Mr. Partee is leaving. Obviously, the President is going to appoint a majority of the Federal Reserve Board within the next few months or a year or so at least.

Have you been consulted on Federal Reserve appointments?

Mr. VOLCKER. I have had some conversations.

Senator PROXMIRE. You've had interesting conversations?

Mr. VOLCKER. I have had some conversations.

Senator PROXMIRE. Some conversations. Have you interviewed any of the potential candidates?

Mr. VOLCKER. I have talked to some candidates. I don't know whether they were self-motivated candidacies or otherwise.

Senator PROXMIRE. Well, have you worked with the Treasury Department or the White House in discussing the possible ones?

Mr. VOLCKER. I've had some discussions, yes.

Senator PROXMIRE. What would be your reaction if the President should nominate a candidate whom you felt was clearly unqualified?

Mr. VOLCKER. I would hope that that would not be the case, obviously, but you asked what my reaction would be.

Senator PROXMIRE. What would you do about it.

Mr. VOLCKER. There's nothing I can do about it. He makes the nomination. I will sit there and run the meetings of the Federal Reserve Board and proceed.

Senator PROXMIRE. Well, it seems to me there's lots you can do about it. I think that you have—there's nobody in the country who has more prestige in this area than you have. It seems to me you could go to the President. You could come to the Congress. You could make a public statement. I think we'd be very much influenced by it. I think it would have a profound effect.

The President has shown again—he's just showing now in South Africa—that he changes his mind when the right kind of opposition occurs.

Mr. VOLCKER. Well, I will proceed on the assumption that that kind of contingency won't arise.

Senator PROXMIRE. Well, I'm hopeful that you become as active as possible. I understand the difficulty of discussing this matter, but I think that it's such a critical determination for our country and the kind of monetary policy we have in the future, whether we have inflation, whether we have a stable economy depends so very much on appointments that I think that the wiser the counsel the President can get and the more careful concern we have on the qualifications of the people who are appointed to this position, the better.

Mr. VOLCKER. Well, I certainly have a concern, but I'm not going to presume that those kinds of concerns aren't on their minds as well.

INCREASE IN ALL TYPES OF DEBT

Senator PROXMIRE. On September 4 and again on September 6, Leonard Silk had articles in the New York Times which you may have seen on the overall debt, the total debt of the country. He pointed out that the total debt had increased from $3.3 trillion in 1977 to $7.1 trillion at the end of 1984.

He pointed out that the increase in corporate debt had been very sharp and that the increase in private debt had dwarfed the Federal increase.

Mr. VOLCKER. I don't think that's true. They're both increasing fast, but the Federal debt has been increasing even faster than private debt.

Senator PROXMIRE. Well, yes, but the Federal debt he pointed out had increased during that period $734 billion compared to $2.3 trillion.

Mr. VOLCKER. In absolute amount. The rate of growth of the Federal debt has been even faster; but they're both too fast.

Senator PROXMIRE. At any rate, would it be possible for you to direct your experts in the Federal Reserve to give us a study of the total overall debt picture, the extent to which it might constitute a danger? What I've been talking about is in nominal terms, which obviously is distorted because of the inflation situation.

Mr. VOLCKER. But it's also large in real terms.

Senator PROXMIRE. In real terms it's very large, yes, indeed; but in relationship to personal income and in relationship to gross national product and so forth, so we have a picture of the kind of situation the country is getting into. Could you do that?

Mr. VOLCKER. Yes.

[The following information was subsequently supplied for the record:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

November 8, 1985

The Honorable William Proxmire
United States Senate
Washington, D.C. 20510

Dear Senator Proxmire:

I am pleased to respond to your request for information and commentary on the rapid growth of debt in our economy. Enclosed is some material compiled by Board staff to provide a quantitative picture of the recent debt expansion, the sources of growth, and the effects on the financial positions of households and firms.

The speed of debt growth does concern me. So far, the mounting debt burdens have not in any clear way proven an obstacle to the overall expansion of the economy, but I don't believe current trends are compatible over time with economic and financial stability.

The staff's exhibits show quite dramatically the distortions of financial relations caused by the fiscal posture of the federal government. The persistence of deficits of such awesome dimensions worsens our long-run prospects for economic growth, ensures that a substantial portion of our future income will have to be sent abroad to finance indebtedness to foreigners, and perpetuates the difficulties of our industries that compete in world markets. By contributing to high real interest rates, the deficits help to support a high exchange value of the dollar, weakening the ability of farmers and others exposed to trade pressures to repay loans. Moreover, the rapid growth of federal debt exacerbates financial problems elsewhere in the economy. The high real interest rates raise the debt service costs of all borrowers, including those overseas with debts to U.S. banks.

Borrowing by private sectors also is of concern, particularly to the extent that heavy leveraging may have increased the vulnerability of some firms and individuals to adverse market developments. An aspect of our financial environment conducive to borrowing is the structure of our tax system. The current code encourages both households and businesses to finance purchases with debt rather than with savings or equity. Tax reform proposals currently under consideration by Congress contain some provisions, albeit

limited in scope, that would reduce these incentives by lessening the double taxation of dividends and limiting the deductibility of interest payments; other steps in this direction may well be worth considering.

As a regulator of financial institutions, the Board is especially concerned with the risks accepted by such institutions in the process of creating new debt. If we are not careful, mistakes made by some can spread financial stress to many others through ever more complex financial interrelationships. At the first level of responsibility, it is incumbent on creditors to exercise due caution in their lending activities and to analyze credit quality risk with great care. But beyond that, we also are considering more explicit rules regarding capital needed to support off-balance sheet risks, and, as I told the Banking Committee in September, I think the possibility of increasing bank capital by adding a layer of subordinated debt to current capital adequacy requirements is an idea which deserves further study.

I hope you find these comments and the enclosed report useful.

Sincerely,

Paul

Enclosure

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Recent Debt Growth

Debt has grown at an extraordinary pace in the United States over the past few years. Indeed, the percentage increase in the outstanding debt of domestic nonfinancial sectors in 1984, at more than 14 percent, was the biggest on record. As chart 1 shows, the growth of debt in "real" terms--that is, after deducting the rate of inflation--has been even more exceptional in comparison with the experience of the preceding quarter century.

The expansion of debt has vastly outpaced that of nominal gross national product since 1981, a marked departure from the pattern of the 1960s and '70s. As a result, documented in chart 2, the ratio of debt owed by domestic nonfinancial sectors to GNP has risen from about 1.4 in 1981 to more than 1.6; moreover, available evidence points to a continued sharp rise in this ratio over the remainder of this year. (Scaling debt by domestic spending rather than GNP--in consideration of the implications of the divergence of domestic spending and production as the trade deficit has widened in recent years--changes the picture only slightly quantitatively, and not at all qualitatively.)

Federal Government

As chart 2 makes apparent, the rapid growth of debt in the last few years reflects in large part the exceptional size of federal government, rather than private, borrowing. Between the end of World War II and the mid-1970s, federal debt had declined relative to nominal GNP. The ratio of federal debt to GNP then was essentially stable until 1981, when it began a marked rise. In a cyclical context, heavy borrowing by the federal government historically has occurred during economic recessions and has diminished during expansions; thus the persistently massive credit demands of the federal

sector in the current expansion have added atypically to pressures in financial markets at a time when demands of private sectors also have risen, in conjunction with expanding economic activity.

State and Local Governments

Although credit usage of the private sector--defined to include state and local governments as well as households and nonfinancial businesses--has moved more in line with the expansion in economic activity than has borrowing by the federal government, the ratio of private sector debt to GNP has risen noticeably in the past couple of years. Chart 3 shows that, in particular, the debt burdens of the household and business sectors have risen to record high levels. The ratio of state and local government debt to GNP lately also has been on the rise.

Aggregate state and local budgets have been in surplus since the last recession, but state and local borrowing nonetheless has been very large. In addition to funding traditional public programs, some of the borrowing has funded programs with essentially private purposes--mortgages on single-family houses, in particular. This year, a large share of the new debt has been issued for the purpose of refunding old debt at some future date; because the funds obtained are invested in Treasury securities in the meantime, such borrowing has had little impact on general conditions in credit markets, though the heavy issuance of tax-exempt securities has contributed to upward pressures on municipal security yields relative to other interest rates.

Nonfinancial Business

In the business sector, the ratio of aggregate debt to GNP decreased during the first year of economic recovery, when investment spending was low,

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but, since the start of 1984, it has increased rapidly. Substantial improvements in cash flow have outpaced increases in expenditures on fixed capital and inventories, holding down the business sector's underlying external financing needs. At the same time, however, an extraordinary pace of mergers, leveraged buyouts, and share repurchases has retired enormous amounts of corporate equity--far in excess of new issues (table 1). The bulk of these retirements has been financed by credit and this is the primary factor in the recent rise in debt-equity ratios (table 2). From the end of 1983 to last quarter's close, debt-equity ratios of nonfinancial corporations--whether based on balance sheet data or based on market values--show appreciable increases.

While these aggregate measures are not now at exceptional levels, the aggregation masks declines for some firms which have been offset by increases, often very large ones, for other firms and even whole industries. Reflecting this divergent behavior, recent bond rating changes show a large number of upgradings but an even larger number of downgradings, an unusual pattern during an expansion period (chart 4). For some firms, changing business opportunities may have altered investors' perceptions of the most desirable debt-equity ratios. Where cash flow has risen relative to investment needs, more funds are available for return to investors. Because interest payments are tax deductible, returning funds in the form of interest payments rather than dividends lowers taxes, encouraging firms to replace equity with debt.

Even in such cases, however, the changes to balance sheets have been so dramatic that there is a danger that excesses have occurred. Clearly,

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firms that have increased their leverage are now more vulnerable to a period of weakness in their line of business. They also may be more vulnerable to a run-up in interest rates. While interest coverage ratios have improved with the decline in interest rates and the improvement in earnings over the past three years (chart 5), average maturities of outstanding debt have been shrinking steadily, and the portion of nonfinancial corporate debt that comprises loans and open market paper--a proxy for shorter term or floating rate instruments--now exceeds 50 percent of the total (chart 6). Thus, any future increase in interest rates likely will be felt more fully and quickly than ever before.

Firms appear to have borrowed in short-term markets mainly because the cost of long-term funds has been high relative both to historical norms (especially in real terms) and to the current cost of shorter term funds. Investors' fears of the future consequences of large deficits probably are responsible in part for the steepness of the yield curve. In addition, the heavy volume of federal borrowing in long-term bond markets has added substantially to total demand for long-term funds, possibly crowding out corporate borrowers from these markets. Scaled by GNP, new offerings of 20- and 30-year Treasuries have tripled in recent years while those of long corporate bonds have been halved. During the past 2-1/2 years, Treasuries have accounted for more than 3/4 of total new long-term volume (table 3). Firms also may be willing to borrow more heavily in short-term markets because they are ensuring access to credit by obtaining loan commitments or hedging their interest-rate risks by making interest-rate swaps or by buying interest rate futures or options. These hedges, while they do not eliminate risks, transfer them to others who may be better placed to bear them.

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Households

Recent rises in household debt also are especially noteworthy. Relative to disposable personal income, both mortgage and consumer debt have moved to new highs after a long period of stability (chart 7). Some of the surge in consumer borrowing may be attributable to increased use of credit cards as a convenience in making payments, but this probably can explain only a limited share of the debt expansion. And though household financial assets also have grown along with debt, much of the growth has been in illiquid forms such as pension plan assets or IRAs. Consumer loan delinquency rates, which were very low not long ago, have risen to moderate levels, while mortgage delinquencies have remained high throughout this expansion (chart 8).

One notable change in the composition of household debt is the increase in variable rate borrowing. During the past two years, more than half of new conventional mortgage loans have had adjustable rate features. Interest rates that move with market rates also have become more common for consumer loans as well, accounting for about 10 percent of new loans in recent quarters. Although these loans may carry significantly lower initial rates, borrowers might find their debt-servicing ability pinched if rates were to rise much.

Financial Markets and Institutions

Despite the rapid accumulation of debt, market indicators do not reveal generalized concerns about credit quality. Yield spreads among debt issues of differing quality (chart 9) remain relatively low, and new issue markets remain receptive to securities of less than "investment" grade.

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Still, more localized problems have been plentiful, even as the business expansion continues. In a few industries, heavy debt loads have heightened difficulties brought on by disinflation and sectoral imbalances. The farm credit problem is obviously one of these. In many instances, farmers borrowed at high interest rates to buy land at prices justified only by expectations of high and rising food prices. With the slowing of general inflation and with the huge government borrowing, which helped push up the dollar and drive down crop prices, those expectations were not met. In the mortgage area, many of today's problems stem from debt incurred on the basis of an assumption of continued rapid rises of real estate prices. Increased problems of depository institutions in their energy loan portfolios also reflect decisions predicated on continued high prices and anticipated increases.

Problem loans in these and other areas have contributed to the difficulties of many banks and savings institutions. Banks also continue to be faced with uncertainties regarding their international credits, and thrift institutions still suffer from mismatched balance sheets. Increased use of ARMs has improved balance sheets, but, in some cases, eagerness to qualify borrowers has led to an increase in credit risk, at least partially offsetting the reduction in interest rate risk. The potential for future problems resulting from other innovations is also a concern. The rapid growth of credit has been accompanied by vastly increased use of low-rated bonds, leveraged buyouts, securitized loans, off balance sheet financial guarantees, and other techniques with which we have little experience and for which the magnitude and distribution of risks are not entirely clear.

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Foreign Borrowing

One of the most unusual aspects of recent credit growth is the extent to which it has been financed by foreign funds. Because the federal deficits have been so huge and have absorbed so much saving, the strength of investment spending has depended on saving from abroad which has been invested here (chart 10). At the same time, however, these foreign inflows are necessarily accompanied by large trade and current account deficits. Some of the domestic industries most affected, like farming, are among those with the biggest debt problems. From a longer perspective, foreign borrowing on such a large scale raises the specter of burdensome debt service costs to foreigners in the future.

Our present external position clearly is unsustainable: among other things, it would imply a buildup over time of claims against the United States in volumes that foreign investors could not be expected to hold willingly. Nonetheless, if the capital inflows were to be reduced, those funds would have to be replaced or interest rates would rise sufficiently to squeeze out a sizable portion of our net investment. Higher rates, in turn, would create or intensify financial pressures for many firms and households. The key to maintaining investment that is essential to the nation's long-run economic health is a reduced federal budget deficit, which would free up more domestic savings.

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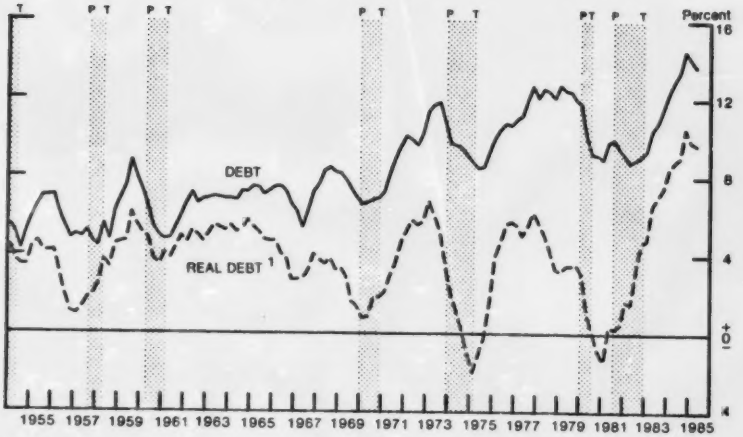
Chart 1

Growth of Domestic Nonfinancial Debt, Nominal and Real

Four Quarter Growth Rates



1 Nominal debt deflated by GNP deflator

Chart 2

Domestic Nonfinancial Debt

Relative to Nominal GNP

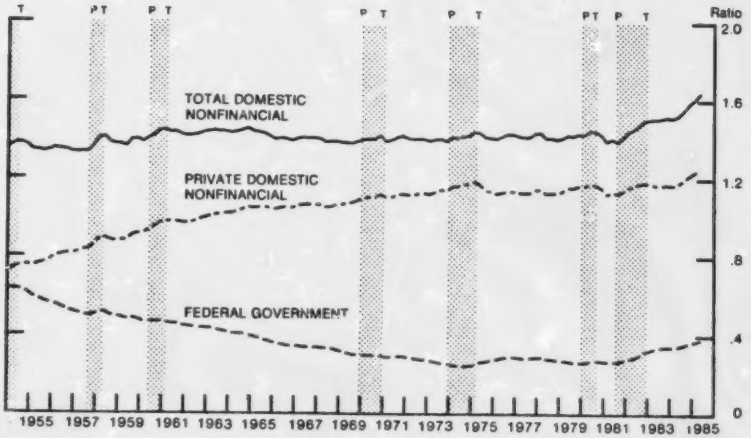


Chart 3

Private Domestic Nonfinancial Debt by Sector

Relative to Nominal GNP

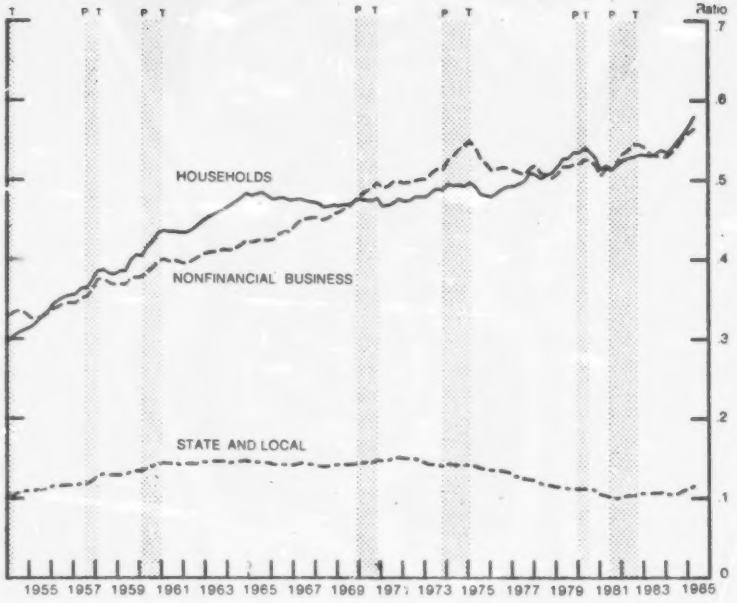


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Table 1

Offerings and Retirements of Equity by Nonfinancial Corporations

	Offerings (including private sales)	Retirements[1]	Net change
	billions of dollars, annual rates		
1980	21.1	8.2	12.9
1981	21.5	33.0	-11.5
1982	28.9	17.5	11.4
1983	40.0	11.7	28.3
1984	18.0	92.5	-74.5
1984-Q1	18.3	76.8	-58.5
Q2	20.3	120.8	-100.5
Q3	15.0	82.2	-67.2
Q4	18.3	90.0	-71.7
1985-Q1	19.7	104.0	-84.3
Q2	27.9	95.0	-67.1

1. Includes equity retired through mergers, leveraged buyouts, share repurchases, and other restructuring plans.

Table 2

Debt-to-Equity Ratios
Nonfinancial Corporations

End of period	Debt (par)[1] / Equity (current)	Debt (market)[2] / Equity (market)
	percent	
1962	42.5	42.4
1964	45.4	37.7
1966	47.4	43.4
1968	50.5	35.6
1970	50.7	48.0
1971	50.7	46.7
1972	50.3	45.4
1973	48.9	61.9
1974	43.8	91.1
1975	41.6	72.0
1976	41.1	72.9
1977	41.4	84.0
1978	41.1	87.5
1979	39.9	79.0
1980	37.8	60.2
1981	38.3	70.0
1982	40.1	71.1
1983	40.7	63.3
1984	46.1	74.3
1985-Q3[e]	48.5	76.3

e--estimate
1. Debt is valued at par, and equity is balance sheet net worth with tangible assets valued at replacement cost.
2. The market value of debt is an estimate based on par value and ratios of market to par values of NYSE bonds; equity value is based on market prices of outstanding shares.

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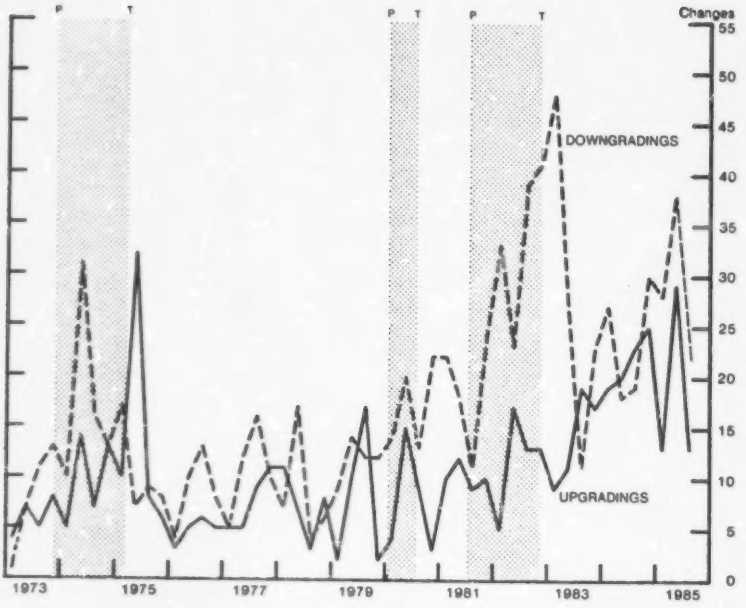
Chart 4

Changes in Ratings of Corporate Bonds [1]

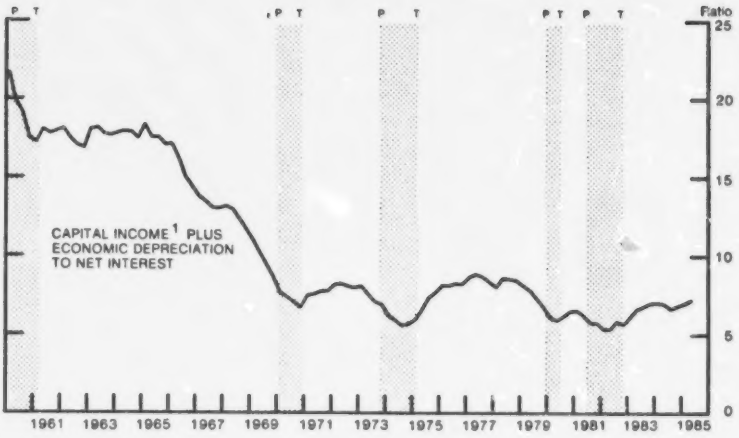


[1] As determined by Moody's Investors Service

Chart 5

Net Interest Coverage

Nonfinancial Corporations



[1] Capital income equals net interest plus before tax profits plus capital consumption adjustment and inventory valuation adjustment. Commerce Department data

Chart 6

Short-Term Debt as a Percent of Total Debt Outstanding

Nonfinancial Corporations

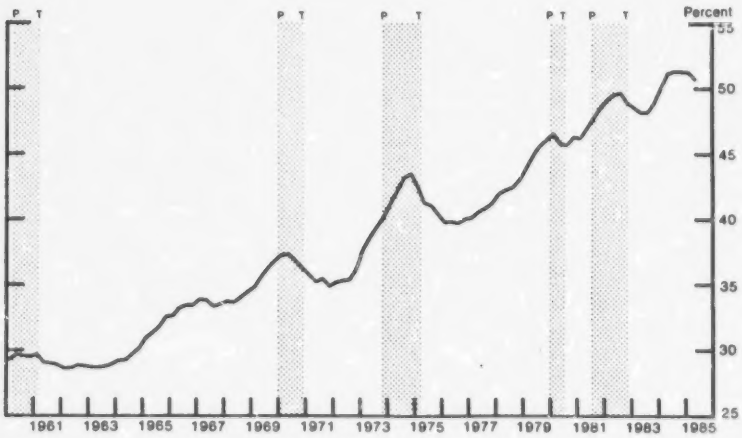


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Table 3

Public Offerings of Long-Term Bonds

Period	Bonds with maturities of 20 years or more		
	Corporate[1]	Treasury	Total
	percent of GNP		
1979	.62	.33	.95
1980	.69	.29	.98
1981	.40	.51	.91
1982	.34	.33	.67
1983	.35	.88	1.23
1984	.22	.99	1.21
1985-H1	.33	1.07	1.40

1. Excludes convertible bonds.

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Chart 7

Household Debt and Principal Components

Relative to Disposable Personal Income

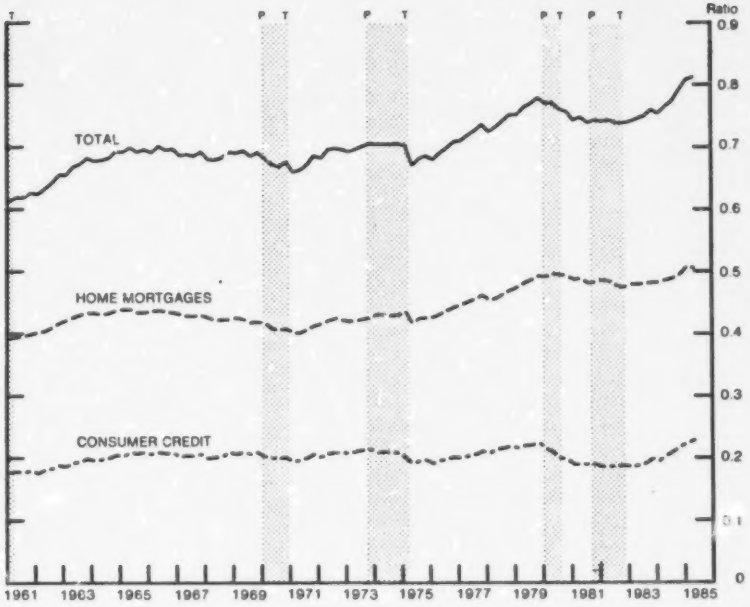

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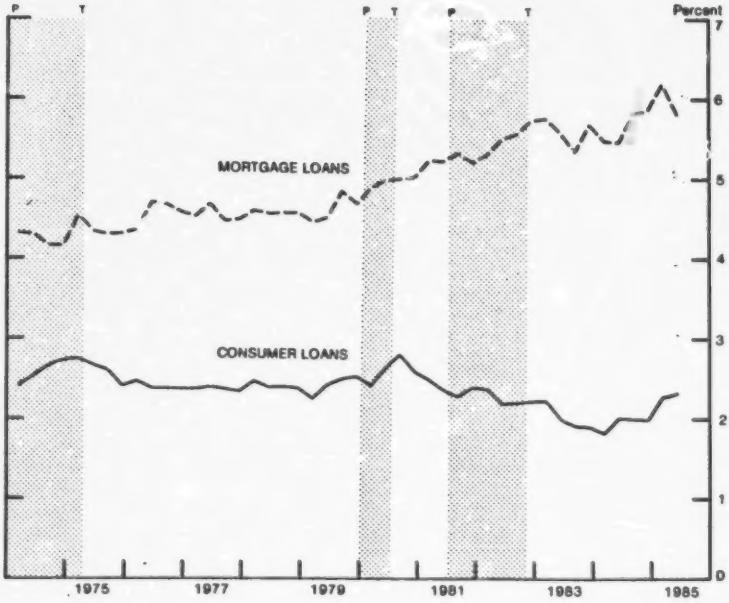
Chart 6

Household Delinquency Rates[1]



1 Loans delinquent 30 days or more. Consumer data from American Bankers Assn., closed-end credit only; mortgage data from Mortgage Bankers Assn.

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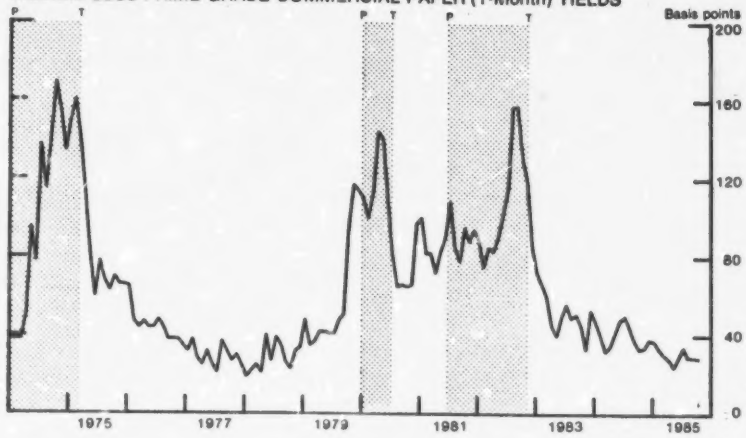
Chart 9

Yield Spreads Between Debt Instruments with Differing Credit Quality

(a)

MEDIUM LESS PRIME GRADE COMMERCIAL PAPER (1-Month) YIELDS



(b)

RECENTLY OFFERED A-RATED UTILITY LESS 20-YEAR TREASURY BOND YIELDS

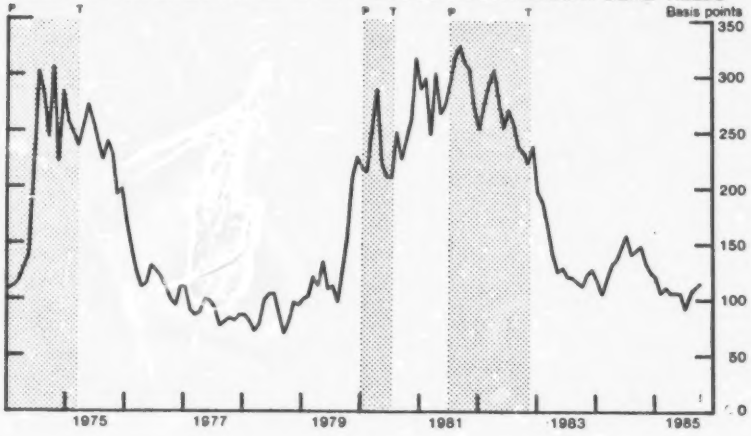


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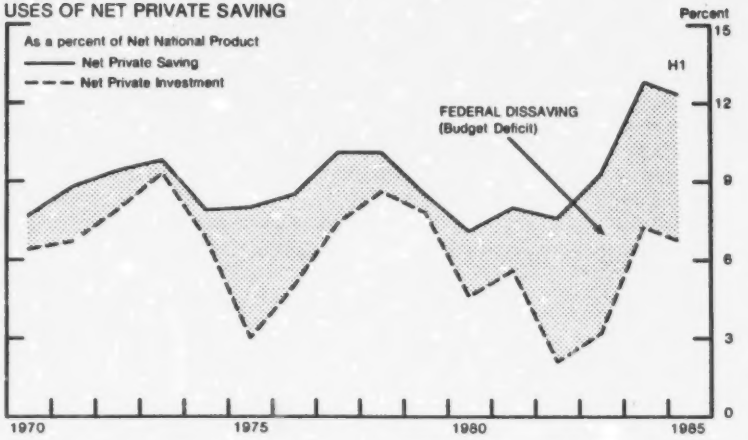
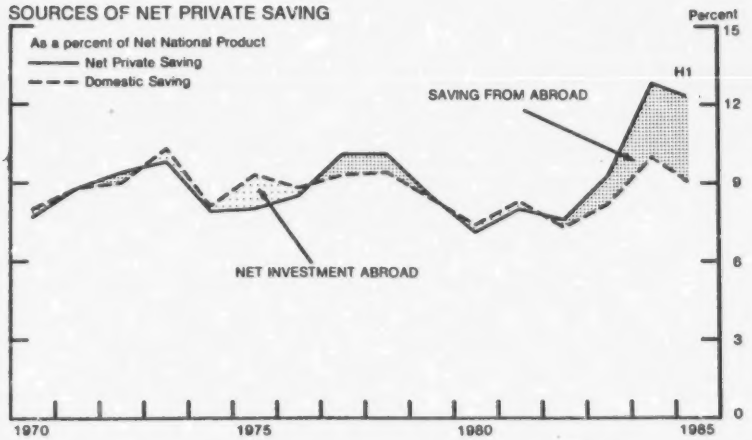
Chart 10

Uses and Sources of Net Private Saving [1]

(a)



(b)



[1] Includes net savings from abroad and by domestic households, businesses, and state and local governments. Commerce Department data.

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United States Senate

COMMITTEE ON APPROPRIATIONS
WASHINGTON, DC 20510

SEP 13

September 12, 1985

#179

Mr. Paul A. Volcker
Chairman
Federal Reserve Board
20th St. & Constitution Ave.,N.W.
Washington, D. C. 20551

Dear Paul:

During the hearing on Wednesday, September 11th, we discussed the worrisome recent rise in total public and private debt in America. You agreed that a study of this issue by the Federal Reserve Board would be a good idea.

Here are some of the issues which I believe should be examined:

1. The size of the total debt in relation to the economy and how this relationship has changed since 1970 in both nominal and real terms.

2. The composition of the debt: public vs. private, corporate vs. other private, long term vs. short maturity, national vs. international and any other classification which you think would shed light on the problem.

3. The source of funds for this debt: private/corporate savings, state and local surpluses, foreign investment, etc.

4. The most troubling aspects of the rise in debt i.e. the areas of greatest vulnerability.

Any thoughts you have regarding the policy implications of the data would be welcomed. What should the Congress do to minimize the vulnerabilities?

Thank you for your assistance and warmest personal regards.

Sincerely,

William Proxmire, U. S. S.

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Senator PROXMIRE. Can you give me just offhand your feeling about the increase in total debt and its significance?

Mr. VOLCKER. I think it's worrisome. The worries increase the longer it persists, and we don't know how long it will persist. It's one of the puzzles. But it's been going on for 2 or 3 years now, at an exceptionally rapid rate of speed relative to the gross national product.

I think, in a broad sense, it reflects a greater leveraging of the American economy and its businesses and individuals, and when you get greater leveraging of that sort it implies greater financial vulnerabilities. And given strains and pressures we have in any event, it's somewhat disconcerting to see this rapid rate of debt growth.

Senator PROXMIRE. Now the most conspicuous immediate problem is with respect to farm credit. Officials of the Farm Credit System are saying that the System is broke, that a multibillion Federal bailout will be needed.

Do you agree with that assessment? If you do, what changes in the system would you recommend to ensure that similar failures don't occur in the future?

FARM CREDIT SYSTEM WELL CAPITALIZED

Mr. VOLCKER. I don't agree that it's broke. I don't know enough about it in any event. That system is strongly capitalized and I am not in a position to have as close an evaluation of their loan portfolio as they themselves do. I do know that they both have a lot of pressures in that area, there's no doubt about it, but, fortunately, they are relatively strongly capitalized as well.

I know there's been a lot of discussion, a lot of concern, by people in the system as to whether the degree of control centrally is really adequate and sufficient. Weaknesses in that area have been revealed by what's gone on in recent years. There's been a large amount of lending by the Farm Credit System in relatively recent years, when farm land prices were at their highest, and a liberalization of credit standards, as I understand it, at that point. These things always raise more questions in retrospect than they do at the time, but I think there are questions as to the controls within the System and the relative autonomy of the different parts. That's obviously a very difficult question. They have taken great pride in the autonomy of the local lending decisionmaking.

Senator PROXMIRE. Now if Congress does bail out the Farm Credit System, commercial banks with a high concentration of agricultural loans are likely to demand similar relief.

What's your assessment of the commercial banking industry's exposure and should Congress step in with net worth certificate assistance or a similar measure or will the problems work themselves out, in your judgment?

Mr. VOLCKER. I think some of these pressures are obviously reflected in commercial banking system exposure to agriculture as well. By and large, I think the commercial banks' exposure is more conservative than the Farm Credit Administration's and certainly than the Farmers' Home Administration, which tends to have the

weakest borrowers and the weakest loans. Even a heavily engaged agricultural bank is not as heavily committed to agriculture as the Farm Credit Administration, so you have that element of protection, too.

Fortunately, like the Farm Credit Administration, those banks have been relatively strongly capitalized, so you have a situation where we have seen some failures of those banks and we're going to have more failures, without any question—we've had more this year. But is it a situation that can be managed? I think in most scenarios that one can think about—given some time, over the next several years, without all the pressures converging on them all at once—it should be manageable by the great bulk both of the borrowers and of the banks.

Senator PROXMIRE. So you think the principal problem as far as the amount of losses and so forth are concerned is with the farm credit banks, the cooperative banks, who are concentrated in agricultural loans and have no diversification.

Mr. VOLCKER. They are in a more potential crisis situation. There are certainly lots of problems in agricultural banks, and I don't want to minimize those. I think it is fortunate that, historically, they've had a good cushion of profits and capital that is going to enable the great majority of them to see their way through this situation.

Senator PROXMIRE. My time is up, Mr. Chairman.

The CHAIRMAN. Senator Mattingly.

Senator MATTINGLY. Thank you.

Mr. Chairman, is it your position that after Continental Illinois that certain institutions can be so large that allowing them to fail would have a detrimental effect throughout the domestic and international economy and, therefore, that the Federal Government would prevent their failure?

Mr. VOLCKER. I think it's unquestionably the fact that a very large institution entwined with a lot of other banks and other institutions is going to have a bigger effect on the economy nationally and internationally than a small one. But my general approach toward your question is—I speak broadly now, not just of deposit insurance—I think our attempt is to try to save them all. Now it's not always possible and you make those judgments on the basis of relative cost and impact on the community, narrowly or broadly defined.

Senator MATTINGLY. Well, if that's the case, are there other industries that the Fed, as the lender of last resort, would step in to prevent failure, such as textiles, shoes, automobiles, lumber, machine tools, agriculture, and others whose problems result from international competition?

FED ROLE IS PRIMARILY TO THE BANKING INDUSTRY

Mr. VOLCKER. Not ordinarily, but I'm tempted to say if we're going to lend to the banks on an unsecured basis maybe we could extend that to a few other industries as well. But no, obviously, our role is directed primarily toward the banking and financial system. We do have some emergency powers that we are extremely chary of using and have used in very, very limited ways in our entire his-

tory. They exist. I note that they exist, but clearly the whole congressional direction to us is toward the banking system.

Senator MATTINGLY. Well, if you had had the authority back then, would you have recommended they loan Chrysler the money?

Mr. VOLCKER. I think that properly was taken up by the Congress as a question of whether, as a matter of national policy, you wanted the U.S. Government to render assistance then, and that that was much more appropriate than the Federal Reserve having stepped in to lend to Chrysler under those circumstances; I don't think it would have been appropriate for the Federal Reserve.

Senator MATTINGLY. If the Federal Government is going to prevent certain large financial institutions from failing because of their size, wouldn't you agree that that situation would eliminate the incentive to avoid excessive risk? Wouldn't such large institutions therefore enjoy a tremendous competitive advantage?

Mr. VOLCKER. No, I don't believe that this competitive question is nearly as important as some have alleged. As I say, I would try to protect all banks, whatever their size. The Continental Illinois stockholders have lost essentially everything. The management was changed. That's true in bankruptcies of small institutions.

You could argue, in a way, that the insurance system works to the advantage of small institutions because their client base is by definition small and their client base is fully covered by the insurance pretty much whereas in a bigger bank it is not. And the premiums are paid on all deposits. I don't want to carry this point too far, but I think there's something to the point that there are some advantages in being small the way the deposit insurance system is now geared. There may be some disadvantages, but I don't think the difference is all that marked.

If you have a failing small bank situation, typically you find that there are practically no uninsured deposits because of the nature of their business.

Senator MATTINGLY. Let me ask another question. Being a strong supporter of the private sector over the Federal Government, do you think there is a market for or a capability to produce private sector deposit insurance?

I ask that in light of the fact that the securities industry, for example, complains that the Federal deposit insurance gives banks a competitive advantage, and should banks be granted additional security powers, for example, should those who make use of the new asset powers divest themselves of Federal deposit insurance and instead insure deposits through the private sector?

Mr. VOLCKER. As a general proposition, I cannot conceive of a private insurance system doing the kind of job that the public insurance system does. There may be a role for private insurance in supplementing the public insurance, but I don't think you could get a private company with sufficient resources to protect against the kind of systemic risks that public insurance is designed to protect against. And you can't afford—if you're going to achieve the public purposes involved—have an insurance company that may bow out when the going gets tough; a private insurer always has that option of stopping insurance when he thinks the risks are getting a little great. And, of course, they do that.

I don't think we want an insurance system to protect the banking system that would leave an opening for the insurer backing out just when the insurance is most evidently needed.

Senator MATTINGLY. Well, does that give them a competitive advantage?

Mr. VOLCKER. Give who?

Senator MATTINGLY. The banks?

Mr. VOLCKER. Over nonbanks?

Senator MATTINGLY. Right.

Mr. VOLCKER. I think it provides certain advantages for banks over nonbanks, yes. Of course, they pay the premium. I think the whole safety net—not just insurance, but also the existence of the Federal Reserve and all the rest—provides some competitive advantages to banks, which are offset—I don't know how you measure precisely the balance—in concept by regulation and supervision which their competitors do not have. They have limitations on their powers. They do have limitations on their risk-taking, and that's the quid pro quo.

Senator MATTINGLY. Another question. Do you agree with Henry Kaufmann that interest rates are going to go up? Or are they going to come down or are they going to stay the same?

Mr. VOLCKER. Those are the three possibilities. I don't know as I want to comment further.

Senator MATTINGLY. But do you agree with Henry Kaufmann?

Mr. VOLCKER. I haven't seen what Henry Kaufmann has been saying recently, but when I have something to say about interest rates I'll say it directly, I think.

Senator MATTINGLY. Then with you saying nothing, do you expect them to stay about where they are?

Mr. VOLCKER. I'm not going to say anything at the moment.

Senator MATTINGLY. Well, I won't invest any money anywhere then. Thank you.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. I think your statement this morning was quite detailed in terms of your thoughts on what perhaps should or shouldn't be done with respect to deposit insurance and I think in subsequent questions and answers you've made it clear that you don't necessarily see eye-to-eye with Chairman Isaac and you've laid that out I think quite sharply for us to see.

HIGH CAPITAL IN THE FORM OF SUBORDINATED DEBT

Mr. VOLCKER. If I may just interject because this gets back to a question that Senator Garn asked and I didn't allude to it in my answer. I mentioned Chairman Isaac. I do think one of the more constructive approaches—and I am quite intrigued by this idea—a requirement for higher capital in the form of subordinated debt that would under no conditions be protected by insurance. So just let me get that on the record.

Senator RIEGLE. Well, that's an important point. You touched on that, but I'm glad to have you emphasize it. How much latitude do you have in that area to do something about that or would it require a change in law?

Mr. VOLCKER. We can require higher capital requirements now. If I understand it correctly—and the idea obviously needs further elucidation—this would be a kind of special class of capital, so you could have some subordinated debt that got treated like equity, in effect, when the FDIC had to make a payoff or provided some assistance. Now they get caught in a normal bankruptcy kind of procedure where they have to treat all general creditors on a par. This would make clear that subordinated creditors would get less favored treatment. Maybe you can require this form of subordinated debt within existing law—I would have to look at that a little more carefully. I have a feeling that it would be hard to achieve all the purposes he has in mind within existing law, but we could look at that.

Senator RIEGLE. The bankers have already addressed that issue here, yesterday as a matter of fact. They are not terribly enthused about that idea, as you might guess.

Mr. VOLCKER. I understand that.

Senator RIEGLE. But I think if you believe that's an idea that has some promise, in addition to the question of what kind of regulatory latitude you might now have, you ought to take a look at it and give us your thoughts. And if you've got a recommendation to make, if it appears that a change is needed——

Mr. VOLCKER. We have thought about it. We haven't attempted to develop a detailed plan or scenario. And I would also point out in reference to the concerns that I'm sure you've gotten from banks and thrift institutions, a rather large amount of equity or subordinated debt would be involved, and this would have to be phased in over a very substantial period of time.

Senator RIEGLE. Well, I think you have emphasized it. I also think that if you believe the problems require changes in the present law, then we need to hear that from you in the form of a letter or however you would want to convey it because the debate is now going on. This is the time period in which we ought to get those recommendations if you get to the point where you think you need to make them.

I would like to pick up on two things that Senator Proxmire was raising. He went over with you as I've done in previous hearings the problem of the buildup of debt in every direction and the greater leveraging of the system—which is the phrase you used—which leads to greater financial vulnerability obviously; which I fully agree with.

At the same time, what's happening, though, is that interest rates now have come down quite a bit. With this new low-interest rate environment, there are an awful lot of efforts being made to persuade people to take on more credit. There are ads in the paper every day to take out second mortgages on homes and a variety of other things.

So there are a lot of sales on credit going on or so it would seem from the advertisements. And one might say that while we would all like to see lower interest rates to the extent that we can have them, that in fact that's part of what encourages the buildup of debt accumulation and overleveraging, so that we reach a point at some time where it seems very dangerous to keep expanding the money supply and making credit available?

Mr. VOLCKER. Yes.

SHARP INCREASE OF M1

Senator RIEGLE. My point then is this, as I've been following what the Fed has been doing—which isn't always clearly stated for obvious reasons—I've seen a very sharp increase in the money supply and other decisions within the Fed which have helped bring interest rates to a lower level than they might otherwise be and, in turn, I think that's helped encourage the taking on of additional debt in all these different directions that we're witnessing.

At the same time you can also need low-interest rates because the economy may look like it's stalling out which could cause a recession or worse. So, while for one purpose you might not want the rapid increase in money supply, for another purpose you might feel you really need to have it.

Mr. VOLCKER. Precisely.

Senator RIEGLE. That leads me to a question I would like to pose.

Mr. VOLCKER. Would you like to be one of those candidates for the Federal Reserve Board.

Senator RIEGLE. I don't think I would pass muster. I'm delighted that you did last time. I don't know what the test looks like today as a matter of fact for me or for you, but if we're perhaps beginning to overleverage ourselves or maybe are already, how do we start to draw back from that problem without at the same time running the risk of driving the interest rates up?

Mr. VOLCKER. You referred to one influence that might induce people to borrow and that is how high- or low-interest rates look. Most of the time people tell me that interest rates still look very high relative to the inflation rate and all the rest. But that certainly is an influence, the level of interest rates, the amount of money being put into the system, and so forth, which may affect those inducements.

But your statement brought out the dilemmas that are involved in this case. When you get a dilemma of this sort you also look at other things that can be done of a structural or short-term nature. Let me just mention a couple.

I do think what we are seeing here in this particular situation is some of the longer run effects of a tax system that is biased in favor of debt and against equity, and that's been true for a long time. The tax reform proposals would take a kind of baby step toward dealing with that.

But as people get more and more used and attuned to that and some other incentives come into play, I think more and more advantage is being taken or exploitation is being made of the advantages of borrowing rather than selling equity, and that points up what I think is a flaw in our tax system that in effect contributes to the overleveraging of our economy.

The other area of attack is the degree to which you can deal with some of these problems more directly. The banking system, the thrift system, are still big providers of debt, directly or indirectly, and in our supervisory and regulatory policies I think we ought to be aware of what's going on in the world at large and drawing

some conclusions as to the types of activities going on in those institutions.

Now I say that without saying those institutions as a group are necessarily the heart of the problem. A lot of this is being generated outside the banking system. But to the extent that the problem is reflected in those institutions, we do have to some degree the supervisory or regulatory leverage to work on.

Senator RIEGLE. Well, you mentioned, for example, earlier in your testimony and in your other responses about the States granting additional investment powers for federally insured institutions.

Mr. VOLCKER. There is no doubt that one area where this is going on is in commercial real estate development or, in some cases, when it gets combined in a commercial deal, residential real estate development. We have what seems to me an anomaly of laws being liberalized in this direction precisely at a time when I think most observers would say the risks of overextension are becoming greater. It's not just a theory; you look around the world, it's happening. You can't pick up the newspaper without seeing examples of it.

Senator RIEGLE. You're saying that maybe we're at a point where we've got to at least modify the insurance system so that we don't spread that insurance protection out over these riskier ventures that are State-granted powers?

Mr. VOLCKER. I don't think of it as modifying the insurance system. I think we ought to modify Federal law or regulation, yes.

Senator RIEGLE. On the agricultural loan problem, you said that you're not an expert on the private agricultural banking system and I don't profess to be either, and I'm not sure we have very many around, though I think we're going to need some pretty soon from the way it looks.

JOINT OVERVIEW NEEDED ON AGRICULTURAL BANKING SYSTEM

I would like to suggest to you, Mr. Chairman, that I think it would be helpful if, some day soon, we were to have a joint hearing with the Agriculture Committee on the problem in the agricultural banking system and the degree to which that may have a bearing to commercial banks that carry substantial percentages of agricultural loans which is true in some regions of the country, so that we might take a look at how these things connect. And if we're going to get hit with a major additional liability that no one can meet and they may come for Federal relief out of the agricultural banking system that we can at least relate that to how that connects to the rest of the banking system.

I think we are at a point where we need to understand that relationship and I would like to suggest that we take initiative some time soon to try to have that hearing so that we can think together about it.

The CHAIRMAN. Well, there are some jurisdictional problems. In a limited aspect of that I have requested jurisdiction. I won't get into the details of it. And the farm community is very upset. They do not want us involved. So where I have tried to assert some jurisdiction, we simply have been rebuffed. They want to keep it in the Agriculture Committee. I have been rather surprised by the reaction.

So I understand what you're saying. I just point out there have been some difficulties with jurisdiction in this area. There has also been overwhelming opposition among the farm community from the Banking Committee getting involved, interestingly enough.

Senator RIEGLE. Well, I would think maybe a joint hearing would be the least offensive thing to do, but I think it ought to be explored.

Just one other thing and then I'll finish, and that's this, Mr. Chairman. When we see examples like Continental Illinois where we move in and go beyond the law to protect everybody—protect the depositors above $100,000 and get them out whole——

Mr. VOLCKER. I wouldn't say beyond the law; beyond the minimum required by the law.

Senator RIEGLE. Beyond the minimum requirements of the law, and at the same time we have other liquidations where you've got depositors above $100,000 that take a bath in other banks within the system, you clearly have a double standard.

Mr. VOLCKER. I think this is more perception than reality. I just give you my own view that where we can do it—meeting tests of costs and so forth, my own view—now I can't speak for the FDIC—is that the basic bias is to save them where you can—that is, save the depositor where you can, not the bank. In fact, there have been relatively few payoffs except during the period—and even then, relatively few—when, as you know, the FDIC adopted this policy of experimenting with modified payoffs. They paid off some banks that may not have been otherwise paid off, but the amount of uninsured deposits in some of these smaller banks that get paid off is often negligible.

The concern is more theoretical than real. When you consider the thousands and thousands of small banks and even just consider the number of small banks that have failed, the numbers that get paid off with any amount of uninsured deposits is negligible. In 1983, as near as I can figure out, nine banks were paid off. They had a grand total of $3 million of uninsured deposits in all of them. In the last couple of years, it was more like $25 million, but that included the period of this experiment in modified payoffs. That was the total number of uninsured deposits in all the institutions that were treated that way; that wasn't the amount of the loss. That, again, was only a fraction of the small institutions that were dealt with, and that's only a tiny fraction of all the small institutions, so I think this perception is greatly exaggerated.

Senator RIEGLE. Well, my time is up. My concern is that there may be instances where we treat one depositor above $100,000 in one institution because it's large differently than we treat that depositor in another institution because it's small, even though we say we've got the latitude within the law to stretch what we do in a given case. If you're not treating those two depositors the same way I don't think it's fair. I think you've got a fairness problem that we're going to have to devise some answer to.

I don't suggest what the best answer is, but to leave it as it is now I think is to build in both a real unfairness and a perception of unfairness we ought not have.

Mr. VOLCKER. I can only repeat that I think it's more perception than reality.

Senator RIEGLE. Thank you.

The CHAIRMAN. Senator Dodd.

Senator DODD. Thank you, Mr. Chairman.

Thank you, Mr. Chairman, for being here with us this morning.

Let me just pick up on that last question very quickly and ask you something fast here and then move on to something else.

The Garn-St Germain Act, looking back at it today, in light of what you see going on out here, would you make some suggestions as to whether or not we maybe went too far with the Garn-St Germain Act and built in new powers? Has that created some of these problems? And would you recommend that possibly the committee relook at that legislation as a way of dealing with some of the problems you're suggesting?

NEED TO AMEND PRESENT ACT

Mr. VOLCKER. I wouldn't relook at that legislation in the sense of drawing back from what was done then. I think—if I may say, with respect, and I don't think the chairman would disagree with this—it was an incomplete piece of legislation. He went as far as he could at that point, but I do think there is an urgent need for supplementing those areas that were left out, which include some new powers. I think what's of concern today is also some limitations.

I have expressed my views on the limitations in extreme cases on what States are doing. I have expressed my views on nonbank banks.

Now I think it is true that some savings and loans have gotten into trouble with the use of the new powers in the Garn-St Germain bill. I don't think there's any doubt about that. I don't think that necessarily says that the provision of those powers was wrong if that's the direction in which you want to carry the banking system. It may have saved some, too. You can point to a number of incidents where this kind of kamikaze attitude that a few thrift institutions have had—that they're going to go out and take some very large risks in the hopes of winning big—was to some extent facilitated by the fact that they had broader powers. I don't think simply because a power is abused that says that a power is wrong.

Senator DODD. You said something in your statement and I think you've pretty much covered at least some of your thoughts on the narrow issue here today, but I happen to agree with you that the fundamental problem here is less a regulatory one, although there are obviously some things we might do legislatively that you've identified rather clearly, but the fundamental problem is an economic one that we're really dealing with. And I'd like to just hit on that a little bit with you if I could here because I'm afraid we probably won't get another chance to see you before this committee before a vote we're going to have to deal with here in a couple of weeks that has to do with that debt ceiling vote—one that we always look forward to every year around here.

The CHAIRMAN. Every year? Two or three times a year.

Senator DODD. And you know what's it's going to become. It's going to become apparently now a platter and a menu that would vie with any good restaurant in terms of the number of issues that will probably be brought up on that piece of legislation, including

trade bills. And I confronted, along with my chairman here, some 300 pieces of legislation on my return here on Monday on my desk. Obviously, we're looking at a situation where in 1981 we had the ceremony of passing the $1 trillion mark in terms of the national debt and we're now going to go through the ceremony 4 years later of passing $2 trillion in debt. And obviously, as you pointed out, the Federal deficit, the trade deficit issues, global debt, all of these questions put not only the economy of this country but the global economy in a very precarious position.

Knowing what you know now, knowing what we all know as a certainty of what occurred over the last 4 years, and certainly, Mr. Chairman, you've testified any number of times up here, in light of that, what would you recommend that we try and do both in the trade area and in the Federal deficit area, seeing the accumulation of the annual numbers each year, seeing tax reform now becoming the President's No. 1 issue—what would you recommend that we do in those two areas?

Mr. VOLCKER. I think the fact that the debt ceiling is before you and you're now at the $2 trillion mark and only a few years after you were at the $1 trillion mark certainly symbolizes the size of the fiscal problem in the country. I don't know what I can recommend to you other than you get after it. But it's not very useful for me to say that. I've been saying that for some time and I know a great many people in the Senate have been trying to do just that, and I haven't got any magic formula for putting it together.

IMBALANCE OF THE TRADE DEFICIT

I would make one comment on the trade situation and its relationship to this problem. You alluded to the general fact that the imbalance in our domestic finances has its counterpart in the trade deficit. There's a great deal of concern about the trade deficit and I certainly would stipulate and agree that it reflects a major imbalance in our economy; it's not healthy, and it's not sustainable.

Having said all that, suppose by some great protectionist measures you could correct the trade deficit all of a sudden. Given what's going on in the rest of the economy, given that Federal budget deficit, what would we do? We're importing about 15 percent or more, net, of our industrial output. We haven't got 15 percent more capacity to meet that at this particular point in time. With unemployment now around 7 percent, it's not evident that we have the employment capability to meet a full correction of the trade balance in a short period of time without putting pressure on some other industries.

The economy as a whole, certainly by world standards, has been doing reasonably well. Now it is gravely distorted in some of its composition. But the point I'm trying to make is you can't add on to what's going on elsewhere in the economy, and you can't add all these pressures on the domestic credit markets which are being offset by the capital inflow and do away with that capital inflow and do away with the trade deficit without getting problems elsewhere. There's no free ride here.

We ought to be working on policies that reduce the trade deficit in an orderly way. Simply jumping on it with a lot of protectionist

measures I think is going to end up causing more problems than you bargained for.

Senator DODD. Well, I think there's a good possibility that's going to happen in the next couple weeks. I think I can anticipate with some certainty that we're going to have resolutions adopted here in a number of industries. Maybe my colleagues may disagree with that, but I think there's a good likelihood of it because we don't have any alternative really to work with it seems to me from the administration, quite frankly, in this area.

I wonder, in light of what you just said—and I agree with your comments about the ability to actually absorb a readjustment in the deficit in trade, a positive readjustment in the trade deficit, but I wonder if you might have some thoughts of your own, Mr. Chairman, on what kind of steps we might be taking. We're not getting any out of the White House.

Mr. VOLCKER. I might say I think the resistance of the President to these protectionist measures is admirable.

Senator DODD. But that's not enough.

Mr. VOLCKER. You say it's not enough, but what are you saying? That he agree to them all? I think he's got to show, in this case, strong resistance and strong leadership, and I think that's what he's doing.

Senator DODD. But you, yourself, say there is a need for some positive move in this.

Mr. VOLCKER. I'm talking about the trade area itself. The constructive approach—I think very fundamentally here, and I don't want to go over it all again—is the budgetary problem. If you want to have a constructive trade policy, that's the way to get it. That automatically releases the resources to make room for the improvement in the trade balance, and that's the heart of the problem.

Senator DODD. So if the President would ask you, Mr. Chairman, what he ought to be doing with his time, instead of barnstorming around the country on tax reform, he might do a little barnstorming on budget deficit.

Mr. VOLCKER. I don't think they need be necessarily incompatible. They're not incompatible in my mind. But I would certainly not neglect the budget deficit. You just went through that debate before the recess.

Senator DODD. Are you familiar with one of the provisions in Treasury II, by the way, the tax reform bill, of the loan loss reserve that there's an effort to tax that area?

Mr. VOLCKER. Yes.

Senator DODD. In light of your testimony here today and the recognized problems in financial institutions generally, were you asked to comment on that at all or was anyone within the Fed? Given the apparent at least the superficial, inconsistency of the troubled financial institutions and an issue like loan loss accounts and now the decision to go ahead and tax them, that may increase the delicacy of the problem.

Mr. VOLCKER. I don't recall, at this point, any discussion. We may have had some. But it's like other provisions of tax reform. From my standpoint as a banking regulator, I'd like to see them build up their reserves as fast as possible, and if the tax treatment is conducive to that, all the better, from my standpoint. But I think

it has to be looked at as part of a larger package. If I look at it from that particular point of view, I have some qualms about it, but I think you can only look at it as part of the bigger package.

Senator DODD. I thank you for that.

Thank you, Mr. Chairman.

The CHAIRMAN. Before I turn to Senator Sasser, if he would permit me just to follow up a little bit on Senator Dodd's question about Garn-St Germain, I realize I'm suspect in defending it.

Senator DODD. I supported you on the thing.

The CHAIRMAN. I understand that very much. But I was a little bit surprised at the Chairman's answer.

STATE-CHARTERED INSTITUTIONS PRESENT PROBLEMS

There are problems of expanded powers out there, as you very carefully and very thoroughly talked about in your opening statement in State-chartered institutions. Because of my involvement in Garn-St Germain we have asked this question in many hearings and have gotten a lot of data from the Federal Home Loan Bank Board. The institutions that are in trouble for the most part through expanded powers are almost entirely State-chartered institutions.

I just wanted to make that point clear because I have not been able to find a single federally chartered institution that is insolvent or has been merged as a result of the additional powers granted at the Federal level in Garn-St Germain.

The area of difficulty is when you get into the area of dual banking and try and make a decision of whether we start overriding State legislatures in their decisions in granting powers because they are far broader in many States than we ever even contemplated in Garn-St Germain. I did want to make that distinction.

Mr. VOLCKER. There's absolutely no question that what you say is true. I haven't done a statistical study defining the ones that have used the precise additional powers provided in Garn-St Germain that might have gotten in trouble, but there's no question that my main concern—and I think it was implicit or explicit in my answer to Senator Dodd—would not be that you repeal Garn-St Germain in any sense. The powers may well be justified and are justified if that's the direction you want savings and loans to go in, to be more diversified, but I am deeply concerned about entirely different dimensions put upon it in State law.

There is a point of policy here without question, and I would like to allow some room for experimentation and flexibility by the States. But I think the point of principle is well-established; for instance, to go back to a constitutional case I learned about in college, where the Federal Government outlawed State bank notes. The question was taken to the court, does the Federal Government have that power, and it was conclusively determined that it did. We have a Glass-Steagall Act now. I'm not arguing whether it's good or bad, but it's governed States as well as national banks in many respects.

When banks were pleading about usury statutes, I didn't hear so much about States rights then, and they didn't seem to have any qualms at all that the Federal Government could override the

States in that area. So I don't think it's a legal or constitutional question, I think it is a policy question.

The CHAIRMAN. First of all, in the case of usury constraints, there's a 3-year override provision where State legislatures had the opportunity to opt out of the Federal requirements. I would say that it's going to turn on the issue of Federal insurance, which is the main purpose of these hearings. I would expect that Congress will not tell State legislatures flat overrides, you cannot allow these powers to State-chartered institutions. But if they want Federal insurance, there are going to have to be some restrictions or you cannot have Federal insurance.

Well, I don't want to take any more of Senator Sasser's time. I just wanted to make sure we are in agreement that the real problem lies in the State-chartered institutions which have gone far beyond anything we have allowed in Federal law or would want to allow.

Mr. VOLCKER. I fully agree with that.

The CHAIRMAN. Senator Sasser, thank you for your courtesy.

FOREIGN FINANCING OF OUR HUGE DEFICIT

Senator SASSER. Mr. Chairman, the United States has become a net debtor country recently for the first time since 1914. We are financing approximately 50 percent of our Federal deficit with funds that are coming in from abroad and I am told that we will finance about $110 billion of the Federal deficit this year with funds from abroad. And when you peel that back, about 50 percent of these foreign funds are Japanese funds.

What would be the impact on domestic interest rates here in the United States if we saw a substantial exodus of this foreign capital that we're utilizing to finance our deficit spending?

Mr. VOLCKER. The answer that I presume you are expecting and that I will give you is, they will be higher from that reason alone. And the only reason I add that little preface is to make maybe a more technical point. That money won't be withdrawn except as our current account deficit moves into surplus. If we've got a current account deficit we have to borrow from abroad. Individual borrowers can withdraw their money, but on balance, we're going to have to borrow abroad. You're raising the question, if more people want to pull their money out, how do you keep it in here? We're going to have to keep it in here, and one mechanism is higher interest rates.

Senator SASSER. So one way to keep it in would be a higher interest rate.

Mr. VOLCKER. Right.

Senator SASSER. Now can you envision a scenario, Mr. Chairman, in which we would see a substantial exodus of foreign capital that we're presently utilizing to finance our deficit?

Mr. VOLCKER. Exodus in terms of meaning less eagerness to put it in the United States, sure, that's possible. All you've got to do is change the attitude of relative confidence there has been toward the United States. That's one factor.

Another reason we have such a big net capital inflow is that we're not lending anything abroad. Ironically, if American institu-

tions had more confidence in lending abroad, we would tend to have less capital inflow because it wouldn't all get bottled up here. If the Japanese or other foreigners who are putting their money in here decide the prospects look relatively better in Europe or someplace else, and they begin channeling a bigger proportion of their new money in that direction, you've got a problem. So there are lots of factors that could come along that would change this equation.

We have been fortunate, I think, in that, under the particular set of circumstances where we've been running high Government deficits, that foreigners have been, on balance, so willing to lend to us and that our institutions have been so relatively unwilling to lend abroad.

Senator SASSER. And it is, I take it then, a question of confidence on the part of the foreign lender and also a question of getting a higher return on their money here as a result of higher U.S. interest rates?

Mr. VOLCKER. It's also a question of confidence of American investors, because we're talking about net figures that reflect the decisions of both foreigners and Americans.

JAPANESE IMPORTS

Senator SASSER. Well, you were discussing with Senator Dodd a moment ago the problem of trade. What would be the impact, in your judgment, of limiting the United States market for Japanese imports? Would that have any impact on Japanese funds that are presently invested in this country? There's been some speculation that if there were a limitation of the United States market for Japanese goods that you could see an exodus of Japanese funds as Japanese companies pull their capital back to their domestic market to make up for loss of profits in the United States market.

Mr. VOLCKER. I thought you were going to ask a different question, almost the opposite side of that coin, whether if we restricted, let's say, imports from Japan, that a continuing capital inflow from Japan and elsewhere would push the exchange rate still higher and tend to offset the administrative measures that you took, or the tariffs, or whatever because that money would come in at the same rate of speed or maybe a greater rate of speed, and the lower imports would mean that the exchange rate would get driven up and you would reach a new equilibrium at a higher exchange rate with pretty much the same imports that you had to start with.

The general lesson I would draw from this is that if you begin fooling around that way, you don't know what the reactions will be, and they may not be happy.

Senator SASSER. Well, would you disagree with some who say that if we limit the United States market for Japanese imports that we would see an exodus of Japanese capital from this country?

Mr. VOLCKER. I'm not sure that that in itself would produce an exodus of Japanese capital. You might argue that some people might want to put some capital in here—I don't think this would be enormous quantitatively—but some people might want to actually invest some money here to build a plant to get in behind the

tariff wall or the quota or whatever, so that would be one factor probably inducing a little more capital to come.

If it's taken as a kind of opening gun in economic warfare between Japan and the United States, you might well get the kind of reaction that you're thinking of. There's occasionally speculation whether the Japanese, on their own, might restrict their capital exports.

Senator SASSER. We had the situation in my home State of Tennessee, Mr. Chairman, when the Japanese were confronted with limitations on the importation of small trucks, Nissan chose to come to my State and start building the trucks there and they have been very successful in that endeavor and, of course, this is Japanese capital coming to this country employing American labor, an effort to get around what were clearly protectionist measures.

They have now expanded that into the production of their small economy automobile, I suppose in anticipation that there might be quotas raised against their automobiles. So the best way to get around that is to build the cheap one here and export the expensive one into the United States market from Japan.

Mr. VOLCKER. I think that's certainly an ingredient in those kinds of decisions and it seems to me they also can have a kind of strategy that some production in the United States may in the long run—if they don't have protection—facilitate a distribution network and all the rest that is going to be satisfied increasingly from Japan, in terms of absolute number, if not relatively.

Senator SASSER. Let me shift gears for just a moment. You've been asked about the farm credit crisis. A study published in July by economists at Wharton Econometric Forecasting Associates indicated that problems could lie ahead for money center banks in connection with the crisis that apparently we're experiencing in agriculture.

POSSIBLE REPERCUSSION OF FARM BANKS COLLAPSE

The suggestion was made that multiple small bank failures in the Midwest could lead to failures among larger banks. The chain reaction, according to the report,

> • • • theoretically could spread through the banking system like a contagious disease, eventually causing the financial system to collapse.

Well, that's sort of a catastrophic view that Wharton Econometric has, but on a more positive note the Wharton economists go ahead to say:

> After the experience with Continental Illinois, there is evidence that the Government, the Fed, and others, would not allow this to occur.

My question to you is: Would you characterize this Wharton study as being unduly alarmist or is there a real crisis that could be set in motion by a domino theory in the agricultural bank sector?

Mr. VOLCKER. All I know about that Wharton study is what you just told me, so I'm not going to comment in any detail.

But I would just make two points. One, the farm crisis in real terms and the farm problems in financial terms are very real, just looked at in terms of the impact on those people and those finan-

cial institutions. The prospect of that situation—even taking a pessimistic scenario of it, spreading like wildfire through the banking system as a whole, I do not share, partly because that's why we're here. There are interconnections in the financial system. They tend to be less in this area than in some other areas I can think of because farm loans are pretty much handled—there are obvious exceptions to this—at the local level or with banks in that regional area that may have bank stock loans, for instance. That's one way this can be propagated. But I think that is containable.

Now there are exceptions to that. In some big bank branching States like California, there's a lot of agricultural lending by the biggest banks, and it is another major part of their business. It's not big enough in itself to present a threat to those banks, but added to a lot of other problems, it obviously is another consideration.

Senator SASSER. My time is up. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. The Wall Street Journal carried a headline, "Foreign Banks Step Up Lending Competition in the U.S. and Abroad." That article contended that Japanese, British, West German, and other banks are taking foreign and domestic loan business away from American banks. It says that American bankers complain that their competitors have an advantage because foreign regulators permit greater leveraging—that is, more loans in relation to the bank's capital. The extra leverage enables them to charge lower interest rates than the U.S. banks and still earn just as much money as a percentage of total capital.

The article goes on to note, "part of the reason for the higher capital ratios being required in U.S. banks is the Latin American debt crisis."

I note on page 30 of your testimony that you agree we should have our banks increase their capital because in your view, "the added capital would provide an extra cushion of protection against the possibility of loss to depositors and the deposit insurance fund."

Could you give us your views on whether the U.S. banks are being competitively disadvantaged by the recent emphasis on higher capital ratios?

Mr. VOLCKER. I think it's a mixed picture. The banks often complain along the lines that you report in that article. We have devoted some considerable effort, ourselves and through the BIS, to trying to identify the facts in this area and, as any detailed exploration of any of these problems shows, the facts are sometimes elusive. You get into questions of basic accounting standards and all the rest.

But the answer I would give you is it's rather mixed, and I do not think that American banks are generally at a competitive disadvantage in terms of the capital cushions they in fact keep relative to a good many of their competitors, but it's probably true with respect to some countries. And I think it would be desirable to get more international comparability in this area.

It is very hard for us to move toward higher capital standards in the United States against that kind of view that you report, and other regulators would find the same thing in their countries. So there is a certain truth to the fact that it helps us all to move to-

gether, and I think I can say that central bankers around the world, by and large, would be more comfortable moving together toward higher capital ratios; they all face complaints from their individual banks.

A good many other countries tend to have some kind of very crude risk-based capital system, and they are very attached to that, and if we're going to get more international uniformity, which I think we have to to some degree, we don't have to abandon what we're doing now, but I think we may have to supplement what we're doing now with some kind of a risk-based system so that we can work toward more comparability internationally.

INTERNATIONAL AGREEMENT ON HIGHER CAPITAL STANDARDS

Senator PROXMIRE. As to working in international cooperation, are you working in the Bank for International Settlements or elsewhere to achieve international agreement on higher capital standards? If so, what level of capital are you working toward and what are the chances of an agreement that you foresee?

Mr. VOLCKER. We're working in that framework. It's too early to say any specific kind of number. These things turn out to be extremely laborious and go much more slowly than one would wish, but there are very real problems in working on some of these conceptual problems; how do we measure it, what are the accounting standards, what approach toward capital standards shall we use for purposes of looking at international comparability? We're still at the stage of examining those questions.

Senator PROXMIRE. Does subordinated debt as a vehicle offer a way of doing this?

Mr. VOLCKER. That's one of the questions, not in terms of this particular proposal. That hasn't been raised. But the treatment of subordinated debt is one of the issues and different countries do it differently.

Senator PROXMIRE. Now on June 24, the Joint Economic Committee—I'm a member of that committee—held a hearing on the international debt problem. One of the witnesses noted that European banks were in a better position in this matter because they have taken more writeoffs and built large loan loss reserves. That witness stated:

> Europeans are clearly nervous about the health of the U.S. banking system. Every announced S&L failure sends tremors through the foreign markets. An American banker in London admitted that whereas U.S. banks used to pay a little less than others for Eurodollar deposits, since the Continental Illinois collapse depositors have been just as happy to keep their dollars with non-U.S. banks. Virtually every European commercial banker, investment banker, and bank regulator I talked to on my recent visit indicated that he thought U.S. regulators had been too soft on the banks with regard to a realistic reduction of LDC loans and building up reserves against potential losses. They think U.S. banks are faking their books and that perception is dangerous to the large banks that depend heavily on the Euromarket for funding.

Do you think that criticism of our bank regulators has any merit? Do you think our regulators have been tough enough in forcing our banks to realistically value their loans to the developing countries and to build up adequate loan loss reserves?

Mr. VOLCKER. I suppose you would expect me to say and I will say that I think our policies have been broadly appropriate.

This question of the relative reserving or writing down among different national banking systems is about as difficult to pin down the facts on as the capital question that we just mentioned. I think that may be true of some banks compared to American average banks but it's not true of all banks or all banking systems or not true of all American banks. It's a mixed bag.

I do think that—and we do not discourage banks from building up both capital and reserves just as fast as they can. We encourage it.

Senator PROXMIRE. Now at that same June 24 hearing, a senior vice president of Shearson-Lehman Brothers said:

> The banks should consider writing off part of the debt for unless the burden of adjustment is more evenly shared between debtors and creditors the price, both political and economic, could be very high.

That witness stated further:

> Preston Martin is right in pointing to the need for more imaginative schemes. The cost of an interest cap, World Bank guarantees, the stretching of maturities, the cancellation of some debt, is a small price to pay compared to the consequences of economic and political chaos in the developing world and the repercussions in the United States.

Could you comment on that observation? Do you think we must reconsider our current strategy for dealing with this debt in light of the slowdown in our economy and the growing resistance to taking more and more imports from debtor nations?

CONSTANT MODIFICATION OF STRATEGY

Mr. VOLCKER. In a broader sense, we consider modifications in the strategy all the time. I think that this is a major problem and remains a major challenge. I have spoken about moving in actual and symbolic terms, from kind of phase 1, with a lot of emphasis on IMF adjustment, budgetary reform, monetary discipline, exchange rate changes, to a phase of more structural change where we can combine growth with adequate financing. Both are important: You need the structural change; you need adequate financing to produce, in the end, the growth and the growth consistent with servicing external debt. That is the objective, and I think it's feasible but it takes a lot of work.

Senator PROXMIRE. Now on June 17, I wrote to Secretary of Treasury Baker voicing my growing concern about the administration's five-point strategy for dealing with the debt crisis. In particular, I noted my doubts about our ability to sustain the strong, long-term growth required by that strategy and the continued willingness to absorb a vast inflow of imports from the debtor nations.

In his July 17 reply, Secretary Baker agreed that economic growth in the United States would inevitably slow from the high 1984 rates and that this would affect the debt-servicing abilities of countries like Brazil, Mexico, and Argentina. He contended, however, that lower interest rates would offset that adverse impact. He said:

> As a rough rule of thumb, we estimate that a 1-percentage point drop in dollar interest rates would result in a savings due to lower interest payments far exceeding a slower growth in exports to the United States which would result from a 1 percent slow U.S. growth rate.

Do you agree with that rule of thumb calculation? If so, do you believe that Congress' and the administration's inability to agree on a program to make significant cuts in our budget could mean either a significant slowdown in our economy or a real rise in interest rates, either of which would have a significant impact on the debt problem and the ability of the major debtor countries to service these debts?

Let me just say I pursue that line of questioning because the issue is very much related to the question before our committee on bank safety and deposit insurance reform.

Mr. VOLCKER. I can't respond to that rule of thumb just off the top of my head. I know I saw that letter and we looked at it and I can't remember all the assumptions that were made and so forth. I would just have to write to you separately. We'd be glad to look at it.

[Chairman Volcker subsequently furnished the following information in response to a request from Senator Proxmire:]

I am inclined to think that the negative impact on the export earnings of non-OPEC developing countries of 1 percent lower economic growth in the United States may be about half as large as the positive impact from 1 percent lower dollar interest rates for the first year. That may be broadly consistent with the Treasury's rule of thumb. Such calculations, which are rough at best, vary considerably depending on which developing countries are included, how changes in growth rates or interest rates are assumed to be brought about, and how long they persist.

It is clear, however, that continued growth in the United States and in other industrial countries—with continued access to those growing markets—is essential to the economic well-being of developing countries. What is more important than achieving any particular growth rate, I believe, is that growth in the United States and elsewhere be sustained over the long term in an environment of low and stable inflation rates. In such an environment, developing countries can benefit from both growing demand for their output and reasonably low-interest rates.

Let me make one point on slower growth. There's no question that U.S. growth measured as GNP has slowed down this year. What's important to the rest of the world is the growth in our imports and—fortunately or unfortunately, depending upon one's perspective—that import growth has remained very large. Now whether that's sustainable is another question which goes to the budget and a lot of other things.

But we have made a real contribution only not to the debt problem but to the growth of other countries. We have carried them in considerable part on our shoulders and when I look at the problems of growth I think one has to raise the question—and we have raised questions—about what's going on in Japan and Europe. That's where homegrown growth has lagged.

On your point, dealing with the deficit would certainly make this problem as well as many other problems easier to deal with.

LEVERAGING OF CORPORATE AMERICA

Senator PROXMIRE. Now many people are worried about the leveraging of corporate America. Recently a senior official at a large money center bank expressed his concern that in the next economic downturn the problems the banks have had with energy, agriculture, or foreign loans will pale in comparison to the problems caused by some recently financed corporate leveraged buyouts.

Is that an exaggerated concern or will faulty bank loans for this type of activity result in the next major shock to the banking system?

Mr. VOLCKER. Given the amount of problems we've had in some of those other areas, I think that's an exaggeration. But I do think it is a source of some concern and frustration that we are increasing vulnerabilities in the financial system in some directions while we're dealing with others, and one of the vulnerabilities is through this proliferation of leveraged buyouts.

We have an example currently, again rising partly out of these State powers. This EPIC situation in Maryland has many difficulties and many points of weakness, but we have a large amount of those mortgages insured by a mortgage insurance company which in turn is financed with a leveraged buyout of very substantial size. The minute that insurance company comes under pressure, that leveraged buyout adds to the pressures and creates a bank loan in jeopardy.

Senator PROXMIRE. Now there are some who argue that it is no longer possible to maintain a system of financial institutions that specialize in mortgage lending. Those who hold that view argue that the only way to save existing thrifts is to merge them with commercial banks or convert them to commercial banks.

What's your view on the long-term future of the thrift industry? Can most of the industry survive under its current set of powers or are drastic changes necessary?

Mr. VOLCKER. I think what we're seeing at the moment, at the current level of interest rates, is that well-managed thrifts, including those that have remained heavily concentrated in the home lending business, are doing quite well. Their capital may have been depleted and their situation may have been weakened by what happened in the past, but they are potentially on the road to recovery.

Senator PROXMIRE. We had testimony yesterday from the experts in this area who confirmed that and said in fact they're doing better than they've ever done.

Mr. VOLCKER. That's an even stronger view, but I don't think there's any doubt that in a way, here, and fortunately, virtue is being rewarded. Those good solid managements that stayed to their knitting—and I'm sure lived through a period of great strain but nonetheless didn't do foolish things during that period—are now seeing their situation repair itself, while those that went out into other areas very often under the stimulus of State law are now reaping the rewards of undue risk-taking, and they are not healthy. They are beyond help by any decline in interest rates in many cases.

Senator PROXMIRE. When interest rates rise again, as they are likely to, then you have quite a dangerous situation.

Mr. VOLCKER. That is right, and they still are vulnerable to an increase in interest rates. But you asked a general question, is there room for specialized institutions in the home lending area? I happen to believe that there are. It's not a very popular view these days, but I think you can see some examples of it in the savings and loan industry.

That doesn't mean they can all go out and make 30-year fixed-rate mortgages and expect to finance them with overnight money,

but there are appropriately developed techniques—variable rate mortgages, different terms in the mortgages, different terms in the deposits, and more marketable instruments—that, I think, make those risks, to a well-managed institution in fact managable. That doesn't mean they have to be exclusively in mortgages, but I think there is a niche in the market for this kind of institution, and that is why I have urged upon you people that in considering banking legislation you have a so-called thrift test, where they get a certain amount of public support through the home loan banks and otherwise, but they also commit themselves, if they want, to maintain themselves very heavily in residential lending. And if they don't want to do that, that's fine, and then they become diversified and become a commercial bank. But there is room for making a choice and the choice ought to be left up to them.

Senator PROXMIRE. I was disappointed with your arguments for continuing to keep agency enforcement action secret. These are the same arguments made by the banks over the years whenever the agencies required the disclosure of more financial information about the bank's performance. The banks predicted dire results but nothing happened.

It seems to me there's one element of the issue that you failed to address. An enforcement action such as a cease and desist order is generally taken only after voluntary efforts at compliance have failed. In the typical case, the bank promises to make the changes requested by the regulator and then ignores them. From the perspective of the bank, there may be substantial short-term profits to be made by stalling the regulator for as long as possible.

However, if a bank knew that once a regulator got tough by issuing a cease and desist order that it would be made public, it would be far more likely to cooperate during the voluntary phase of the enforcement process.

Wouldn't that strengthen the hand of regulators?

Mr. VOLCKER. I think the situation you described sometimes happens. I would not say that is always the case. Cease and desist by any means, or even in the majority of cases, might often follow a recognition of a problem that the regulators and certainly the bank itself up to then had not recognized, but it comes about rather suddenly and doesn't follow a long period of resistance by the management of the institution.

The precise kind of case that you are concerned with, which certainly can happen, is why I would certainly want to at least retain the right to publish, because we can use that threat, if you will, to induce earlier cooperation than might otherwise be the case.

Senator PROXMIRE. Now as you know, we have three different bank regulatory agencies and one savings and loan regulator at the Federal level. As a result, we have four different notions of capital adequacy. There also have been widely differing accounting principles allowed by the regulators that have a substantial effect on how capital is measured.

Do you think that greater uniformity in capital standards in accounting is desirable? If so, how can we move toward that goal?

Mr. VOLCKER. While uniformity is always nice, the question is, at whose expense? I'm in favor of uniformity when the uniform position agrees with mine and sometimes restive if it's different.

On capital in particular, I don't think there's any problem now. Our standards are very close. We worked very hard and made some compromises to make them close.

There are some differences in precisely the way they're stated and in the treatment of intangible capital, for instance.

Senator PROXMIRE. But there's a great difference between the banks and some of the S&L's, isn't there?

ENORMOUS DIFFERENCE BETWEEN BANKS AND S&L'S

Mr. VOLCKER. There's an enormous difference between the banks and the S&L's and there we don't have the same kind of cooperation in achieving uniformity; but the condition of the industry is very different. It is, in fact, unrealistic and impossible to say that savings and loans can go from where they are today to bank standards. They just can't do it. They can work in that direction, and I urgently or profoundly agree they should be working in that direction and some steps have been made. But even looking toward the longer run future, I don't think we have an adequate degree of consistency.

The most promising step that was taken—and I want to acknowledge it and support it—is that savings and loans that are growing more rapidly have to meet higher marginal capital requirements. That seems to me a realistic way to work toward uniformity and appropriate standards over time.

My concern is that the requirement isn't quite stiff enough, but it's certainly moving in the right direction.

Senator PROXMIRE. Now Citicorp has circulated a paper suggesting that the so-called modified payoff approach to deposit insurance can work even in the case of a large bank failure, provided it is phased in gradually over the next several years.

What are your views on that proposal?

Mr. VOLCKER. My views on that general proposal are reflected in my statement, and I don't know what variant they are thinking of. If you're thinking of a proposal where the depositor, in effect the uninsured depositor, would always be assured of taking a haircut at least temporarily, which is one version of these proposals that was discussed a bit in the Bush task force, I would say that might have some merit for the very long run. Introducing it right now and changing that particular rule right now doesn't have merit; it would have to be phased in over a very long period of time.

I would be in favor of a so-called modified payout right now, if there's going to be a payout. If all the alternatives had been explored and there's a determination that in this particular case there's no alternative to a payout, then it seems to me a modified payout is preferable to existing practice. That's the other extreme. You can make all kinds of variants in between.

Senator PROXMIRE. As you know, the Bush task force recommended, among other things, that the FDIC become the examiner of last resort for any federally insured bank without having to get the advance permission of the bank's primary Federal regulator.

Do you still support that recommendation?

Mr. VOLCKER. I supported the recommendation in the context of the whole report and would continue to support it in that context.

Senator PROXMIRE. Would you support it as a separate item even if all the other items in the Bush package were not enacted?

Mr. VOLCKER. I think it's obvious we would want to cooperate with the FDIC in the case of failing banks. It just reduces itself to a question of who takes the initiative. I think there should be cooperation in this area and I think it works pretty well.

Senator PROXMIRE. As I read the recent *U.S. Trust* case in Florida, the Federal Reserve has ample authority to enforce the Bank Holding Company Act notwithstanding the so-called nonbank bank loophole. That being the case, why don't you use that authority to require the owners of nonbank banks to divest their bank or otherwise bring their activities into compliance with the Bank Holding Company Act and wouldn't that be a logical and prudent step for the Fed to take?

Mr. VOLCKER. You're right. If you look at that Atlanta decision on the *U.S. Trust* case, they told us that we not only had the authority, we must use the authority to eliminate nonbank banks using some language to the effect of "however Congress has muddied the waters" in the precise language of the bill.

Just looking at that decision, if that were the law of the land, your proposal would follow.

Unfortunately, we have another decision in another circuit court that says the opposite. It says we have taken an unduly expansive view of our powers and that we can't limit nonbanks in any way beyond the narrowest interpretation of a demand deposit and a commercial loan. That decision is now before the Supreme Court and we'll get the answer to the question in a few months when the Supreme Court resolves this 180 degree contradiction between two circuit court cases.

Senator PROXMIRE. So if the Supreme Court comes down on the side of the Florida case, then you could step in?

Mr. VOLCKER. Yes, no question.

Senator PROXMIRE. Finally, according to the Bank Board's own figures, about 10 percent of the S&L industry is insolvent. Despite their insolvency, the Board has permitted these institutions to grow at the astonishing rate of over 18 percent a year. Much of the new money taken in by these insolvent institutions is invested in high-risk loans in a desperate attempt to regain solvency. The inevitable result will be more losses by the FSLIC and possibly for the Treasury.

What should be done about these insolvent savings and loans and what can we do now to minimize our future losses?

Mr. VOLCKER. I certainly think they ought to take what steps they can, and I'm sure they have been trying harder in this area, but they've got a big job on their hands to limit that risk-taking that you referred to in your statement and that I referred to in my statement and that we have discussed here.

Otherwise, I can't give you a general answer. I think it depends upon particular institutions. An institution that can't be profitable with the Federal assistance they've already gotten through net worth certificates or whatever in the current environment, I think has real questions about its viability under any circumstances. They ought to be merged, sold, or liquidated in as orderly a way as possible.

Senator PROXMIRE. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Chairman, this concludes the currently scheduled hearings on this subject. However, they will not be the last hearings.

We started with the Chairman of the FDIC and also the Federal Home Loan Bank Board. We will have them back after they've had the opportunity to review all of the testimony that has taken place since their first appearance.

We do have a slight technical problem in that Chairman Isaac is leaving. Mr. Seidman has been nominated. We expect to have his nomination hearings within the next couple of weeks if we can find a mutually agreeable date.

So for everyone's information, we will have additional hearings. I do not know at this time on what date they will be scheduled. As soon as we can get the witnesses together and a new chairman of the FDIC, we will continue with the hearings.

Thank you very much for your testimony today, Mr. Chairman.

Mr. VOLCKER. I appreciate the constructive initiatives that you've taken, Mr. Chairman.

The CHAIRMAN. The committee is adjourned.

[Whereupon, at 11:45 a.m., the hearing was adjourned.]

[Response to written questions from committee members follow:]

[Additional material supplied for the record follows:]

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

November 14, 1985

Chairman Volcker subsequently submitted the following in response to written questions from Chairman Garn in connection with the hearing held before the Senate Banking Committee on September 11, 1985:

Question 1: Should a federal insurance agency be permitted at some point of decline prior to economic insolvency to acquire the stockholder interest for a nominal sum and then arrange a merger with a properly managed institution with any profit after administrative costs arising from the transaction returned to the original stockholders?

Answer: If insuring agencies were given the authority envisioned by this question, they could deal with situations in which a depository institution has profound problems that cannot be resolved by its present ownership in a more timely and expeditious manner than is now possible. Thus, there is an obvious attraction to providing such authority.

But the granting of such authority would not be free of problems. In a great many situations it is far from certain that an institution has reached ... "a point of decline prior to economic insolvency." Subjective judgments would necessarily be involved in exercising such powers, and there would be the possibility that insuring agency supervisors sometimes might act prematurely, causing owners to lose control over banks that, with proper actions on their part, could have been restored to health. Moreover, the process of a Federal agency taking over a depository institution and then arranging its sale might cause an undue decline in the institution's value, so that its owners would not only lose their property but would not receive fair value for it.

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There is a trade-off to be decided on, then. In my view, on balance, it is better that our insuring agencies continue to operate without this added power.

As it is, the Congress has provided the insuring agencies, as well as the Federal Reserve Board and the Office of Comptroller of the Currency, with a broad range of enforcement powers that enable them to deal with problem situations in a relatively decisive manner. For example, the agencies can issue cease and desist orders and capital directives requiring a troubled organization with an eroding capital base to endeavor to arrange an immediate injection of additional capital. The agencies can also use their emergency enforcement powers to issue cease and desist orders to stop unsafe and unsound banking practices that are likely to threaten the solvency of an institution or to stop the substantial dissipation of the institution's assets or capital. The emergency powers of the agencies, in addition, include the ability to suspend immediately an officer or director of an institution when we find it necessary for the protection of the institution and its depositors. And the federal agencies also have a considerable array of means to ensure compliance with these orders and directives, including civil money penalties, U.S. District Court orders and removal actions.

In addition, the FDIC's capital regulation provides that when an insured bank's capital falls below three percent, the bank is subject to termination of insurance proceedings

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unless it has submitted a plan acceptable to the regulators for raising its capital to an appropriate level. Termination of insurance proceedings can, of course, precipitate events which can lead to the early closing of a bank and, therefore, provide a considerable degree of leverage to supervisors.

One action I believe the Congress should take that would help to expedite the resolution of serious problem situations would be to amend the emergency provisions of the Garn-St. Germain Act that establish the conditions under which interstate acquisitions of failed depository institutions are permitted in the event that an appropriate in-state merger partner cannot be found. In particular, as outlined in response to question 9, the Board supports i) permitting such interstate acquisitions without first requiring that the troubled institutions be closed and ii) eliminating or reducing the $500 million asset size cutoff below which emergency interstate acquisitions under the Garn-St. Germain Act are not authorized. These changes would permit a more timely response to certain emergency situations and afford the regulators a broader number of options for handling troubled banking organizations.

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Question 2: If the burden of mismanagement were placed squarely on the managers and stockholders and most failures were handled through a purchase and assumption at an earlier stage - immediately or through a conservatorship - regardless of size - wouldn't this dispose of the fairness question as it relates to large and small institutions? Why couldn't a Continental type solution be applied to failing small banks? If an insurance agency is funded totally by institutions is there a federal subsidy?

Answer: In considering the matter of fairness as it relates to the management and shareholders of failed banks, it should be emphasized that, regardless of the size of such institutions, neither of these parties has been immunized from the consequences of bad decision-making and excessive risk-taking.

Under current statutes and procedures for handling failed banks, the manner in which a failure is resolved can vary depending upon the cost to the FDIC of various alternatives and the importance of the bank to the local community or the financial system as a whole. A failed bank may be closed in which case managers obviously lose their positions immediately and stockholders recover their investments only to the extent to which funds obtained from liquidating the bank's assets are left over after payment of the FDIC's expenses and the bank's liabilities. Most failures over time have been handled through a purchase and assumption transaction in which another banking organization has assumed the liabilities and acquired the good assets of the failed institution, with the FDIC taking ownership of the institution's questionable assets for liquidation. In such transactions, the

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senior managers of the failed bank, lose their jobs and the stockholders of the failed bank recover on their investments only to the extent that the proceeds from the liquidation of the failed bank's questionable assets exceed the FDIC's net costs in effecting the ownership transfer.

The problems of Continental Illinois raised grave concerns because of the potential adverse repercussions that the failure of a bank of its size could have had on confidence in the financial system generally and then on the economy. In light of these considerations, Continental received open bank assistance and, therefore, technically did not fail. Nonetheless, the terms on which assistance was provided required the replacement of all senior management and all involved directors and a very substantial immediate dilution of stockholders equity in the company. Moreover, whether stockholders retain any equity position will depend on the outcome of the FDIC's liquidation of the questionable assets of the company. If "mark-downs" on these assets turn out to be relatively large, the stockholders will lose their entire investments. In any event, they have lost all control over the company.

Thus, the results in the Continental situation were essentially similar to the traditional purchase and assumption transaction as it has been applied to smaller institutions. The Continental-type solution does differ in one way from what happens when a bank is liquidated. In such cases uninsured creditors have suffered losses, something that did not occur in the case of Continental. There has been only a small number of liquidations

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over time, however, and creditor losses in these cases were generally relatively small.

If a deposit insurance agency collects premiums from the institutions whose deposits are insured sufficient (a) to cover losses incurred when certain of these institutions fail and (b) to build up a fund adequate, barring a collapse of the banking and economic systems, to meet prospective losses, then, accepting that important limitation, it would seem to follow that this arrangement provides no direct subsidy to the insured institutions or their customers. It is of course, the case that an important function of a deposit insuring agency is to help prevent a collapse in the banking system by promoting public confidence in the safety of funds held therein. A Federal insurance fund instills this confidence because of its size but more importantly because there is the general view that it is part of the United States government. Without that sense of support the insurance agencies might need to have a larger fund and that would require higher premiums than have been or are currently being paid. In this broad sense, the deposit insurance agencies provide, for want of a better term, a kind of implicit subsidy, but this "subsidy" cannot be measured in financial terms and reflects benefits to all elements of society not just depository institutions.

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Question 3: What can be done to prevent covenants in subordinated debt agreements from requiring the FDIC to prevent losses to all creditors as well as the holding company?

Answer: Covenants that limit the ability of bank holding companies to permit a significant change or dilution in their ownership of subsidiary banks are common in the debt instruments of bank holding companies. Among the debt instruments of the 50 largest bank holding companies, 44 contain covenants that in one way or another limit the acquisition of capital or voting stock of the subsidiary bank by any entity other than the bank holding company. In situations where the bank holding company's subsidiary bank is in need of federal financial assistance and it is proposed to provide such assistance on an open-bank basis by acquiring capital stock of the subsidiary bank, the covenants may limit flexibility in the provision of capital assistance to the bank.

In the Continental assistance program, since an acquisition of capital stock of the bank was prohibited by the covenants in numerous holding company debt instruments, the FDIC acquired preferred stock of the bank holding company, the proceeds of which were invested in common stock of the bank. Rather than providing assistance through the bank holding company, the FDIC could have acquired subordinated debt in the bank and obtained compensation for assuming this risk by taking warrants to purchase the stock of the bank holding company when its condition improves.

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The subordinated debt method was not used partly because of the importance of providing primary capital assistance, rather than credit, to the bank.

If Continental Bank were to be closed, its assets liquidated, and the holding company rendered insolvent, the bank holding company noteholders would have a claim on the assets of the bank that would be senior to the FDIC as a preferred stockholder. If the FDIC had made its contribution via a subordinated note in the bank, its position would have been superior to that of the noteholders of the bank holding company. But, while the subordinated note approach offers advantages in this regard, they are more hypothetical than real since the entire purpose of the federal financial assistance was to prevent the closing of the bank.

One alternative for addressing the constraints on flexibility created by the covenants in subordinated debt agreements would be to limit their application in cases where they interfere with the provision of assistance by the FDIC in emergency situations. This could be accomplished by legislation or regulation. H.R. 15, introduced earlier this year by Congressman Wylie, provided that stock transfer covenants shall not be enforceable in any court where the sale of bank shares occurs in conjunction with an assistance package proposed by the FDIC, or if the sale of bank shares is ordered by the bank's primary regulator. Another alternative would be for the Board to amend the regulations governing bank holding companies to achieve the same result. Consultations are now underway with the FDIC and the Department of the Treasury concerning these alternatives. One important question in these consultations is, of course, whether overriding existing covenants would be appropriate public policy.

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Question 4: Is there a place for self-regulation in the banking industry that draws on the talent within the industry? If so, how could concepts of self-regulation be included in the federal supervisory system?

Answer: The securities industry serves as a good example of where self-regulation has worked reasonably well. Most of the day-to-day regulation and surveillance of that industry is accomplished by self-regulatory organizations, with oversight provided by the Securities and Exchange Commission. And, other examples of successful self-regulation can also be cited. Thus, the extent to which self-regulation will work in the banking industry is a question that can be reviewed.

Effective self-regulation by the banking industry may serve, in some important areas, as a useful complement to governmental supervision of banking. Recently, for example, commercial and investment banks set up a self-regulatory agency for the interest rate swaps market. This market deals in relatively complex contractual agreements, and thus there appear to be clear benefits to be obtained from having industry personnel, given their special expertise gained by first hand experience, oversee practices and procedures in the market. Also, recent arrangements to control and reduce daylight overdrafts, which were developed through the cooperative efforts of private depository institutions, trade groups and Federal banking agencies and to which it appears depositories are willing to comply voluntarily, represent another example of a kind of self regulation by the banking industry.

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There is, in my view, much that the banking industry itself can and should do to strengthen and improve banking practices. Much has been done in the past and efforts should continue and perhaps be strengthened. We should keep in mind, however, that because of the competitive pressures and importance of banking in the economy, government supervision must continue to play a key role in maintaining safety and soundness, in preserving a competitive environment, and in protecting the rights of the consumer of banking services.

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Question 5: What is your view of Mr. Keefe's suggestions that
a. The current loan limit is too high?
b. Many banks fail due to excessive concentration?
c. A bank be required to list its 30 largest borrowers by type of company?
d. The largest banks be required to supply regulators with monthly data?

Answer: a. The legal lending limit for loans to a single borrower by national banks was raised in 1982 by the Garn-St Germain Act from 10 percent of capital and surplus to 15 percent of capital and surplus, plus an additional 10 percent if secured by marketable collateral. Statutory lending limits for state-chartered banks vary from state to state, but generally lie between 10 and 25 percent of capital and surplus.

The avoidance of excessive exposure to a single borrower or source of repayment and the establishment of properly diversified loan portfolios are important principles of sound banking practice. In this regard, the Board of Governors opposed the increase in the legal lending limit for national banks that was enacted in 1982, and it would be appropriate to reconsider this question in the context of recent developments in the banking system.

b. Banks fail for a number of reasons including excessive and protracted losses, the loss of public confidence in the bank's liabilities, and insider abuse and mismanagement. What is common to all bank failures, however, is a shrinkage in asset values to the point that capital is depleted and the bank becomes

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insolvent. Asset concentrations can be a major contributing factor to bank failures since excessive concentrations violate the basic principle of risk diversification.

Federal Reserve examiners review for excessive loan concentrations in the conduct of on-site examinations and highlight in examination reports any concentrations that exceed 25 percent of a bank's capital. While concentrations can contribute to bank failures, it is important to emphasize that a bank's ability to diversify its portfolio is to some degree a function of the geographic location in which the bank is located, the nature of the markets in which a bank can reasonably be expected to lend, and restrictions on geographic location--that is interstate banking limitations--imposed by federal law.

c. Disclosure of appropriate information on the composition of bank loan portfolios can provide market participants and depositors with useful information with which to judge the risk profile of a banking organization. For this reason, banking organizations that file with the SEC are required to disclose data on loan concentrations that exceed 10 percent of total loans. Concentrations in this context are defined in a broad sense as loans to a multiple number of borrowers engaged in similar activities which would cause them to be similarly affected by economic or other conditions.

While this type of information may be beneficial, any type of disclosure scheme that revealed the identity of a banking

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organization's borrowers or its business or competitive strategies could raise questions of confidentiality and invasion of privacy. For this reason, we would not support a rule that required a banking organization to disclose its 30 largest borrowers by name.

d. Under current procedures, banking organizations--large and small--provide the supervisory agencies with financial information on a quarterly basis and, when appropriate or required by the circumstances, more frequently. For example, banks that are experiencing loan weaknesses may be required to provide quarterly or monthly updates on the disposition or resolution of problem loans. In addition to these procedures, we intend to review our need to collect additional information on a quarterly or monthly basis. The imposition of additional reporting requirements would, of course, have to be weighed against the burdens placed upon the banking industry.

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Question 6: Should CPA audits be required of all depository institutions and their holding companies? What steps, if any, should be taken that would permit federal bank examiners to place more reliance on auditors' evaluation of management systems and controls? Would this help examiners focus on asset quality, and bank risk levels, etc.?

Answer: Most large banking organizations, including those that file with the SEC, are audited by outside firms. The Federal Reserve also requires the financial statements of bank holding companies with assets over $150 million to be certified by an independent public accountant. On the other hand, CPA audits are generally not required of smaller companies.

We believe that an adequate audit function is an extremely important aspect of a banking organization's operations, and strongly encourage all organizations to have outside audits. However, we have stopped short of requiring external audits of all organizations by regulation. Smaller organizations typically have internal operations that are less complex in breadth and scope than larger organizations. Therefore, rather than imposing the costs associated with outside audits on these smaller banks, the Federal Reserve has heretofore looked to the banking organization's board of directors to ensure that assets are protected and controls maintained through an appropriate combination of external audits and/or internal audit and control mechanisms. Examiners review a bank's internal audit and control program as well as any external audits during on-site examinations. If the directors and management are not meeting their responsibilities

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in this area, the Federal Reserve will, through supervisory enforcement proceedings, require a banking organization to commence an external audit program, change external auditors if the existing program is inadequate, or take other necessary corrective action.

We believe that it is important for supervisory agencies to work with auditors and CPA firms to improve the quality of bank audits, and to enable examiners, where appropriate, to rely to a greater extent on such audits. In this regard, the Federal Reserve (i) has provided comments on the AICPA's efforts to strengthen bank audit procedures, (ii) permits accountants to review the results of its supervisory examination of a bank providing the bank has given its permission for such a review, and (iii) makes available to the public its bank supervisory manuals that set forth proper procedures and requirements as they relate to sound management systems and internal controls. We also cooperate with the accounting profession in discussing and commenting upon issues and questions that affect the integrity and meaningfulness of financial statements.

Federal Reserve examiners place considerable emphasis on the work of auditors--both internal and external--in determining problem areas within a bank and in setting the scope of an on-site examination. In addition, the work of auditors permits bank examiners to focus greater attention on other critical areas of risk such as asset quality. In general, however, it is my impression at present that the independent audit process in many banks would have to be substantially strengthened to substitute for intensive on-site examination.

As you may be aware there are certain initiatives in the U.K. involving more contact between independent auditors and the banking supervisors. We intend to observe that experience to consider what lessons may be applicable in this country.

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Question 7: Would you recommend that federal depository agency personnel be exempted from government pay ceilings? If so, how can this be effectuated?

Answer: This question is not directly applicable to employees of the Federal Reserve Banks who are responsible for examining banking organizations and for carrying out a principal part of the Federal Reserve's direct supervisory efforts. Reserve Bank personnel are not now subject to federal government pay scales. This is also true of the thrift institution examiners employed by the Federal Home Loan Banks.

The wages and salaries of Reserve Bank examiners are set to be commensurate with those offered by the local banks and other financially related organizations and with the objective of keeping costs down to the extent possible. The wages and salaries of our bank examiners and of all but a few managerial personnel are now below the federal pay ceilings. We may have to raise our salaries in coming months to meet growing competition for quality personnel, but I believe we will be able to do that and remain generally consistent with government pay scales.

I believe there is a particular problem in conforming to government pay scales for top level supervisory personnel. That problem is not limited to banking supervision, however, so the broad policy question as to the appropriateness of a special exemption ultimately is one for Congress. In the absence of more general "top level" adjustments, I do believe a law specifying a limited exemption would be justified.

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Question 8: What is your view of permitting federal regulators to require institutions to pay special assessments for the increased examinations made necessary by their classification as a problem institution?

Answer: The Board of Governors has not taken a position on this specific suggestion; however, the idea appears to have some merit and is worthy of consideration. The Federal Reserve on occasion utilizes a variation on this idea in our supervisory activities. Sometimes when we have reason for concern that a banking organization may have a problem, we require the organization to retain, at its expense, the services of outside auditors or consultants that are to report their findings to us.

I believe, however, that the implementation of the proposal in question would have to provide for flexibility in the imposition of assessments. A main objective of supervisory activities, afterall, is to return problem institutions to financial health if that is possible. And, requiring institutions suffering, say, from deficient earnings to pay extra supervisory assessments during periods of adversity could be counterproductive to the achievement of that objective. To pick a concrete example from today's banking scene, does it make sense to impose added assessments on the many farm banks that are struggling to survive? On the other hand, consideration could be given to deferring such assessments until the institution has been returned to health or, if the bank eventually fails, charging such assessments against the proceeds, if any, remaining after the bank has been closed

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Question 9: How can the bidding process be improved and the cost of managing a failure be reduced?

Answer: With respect to the handling of severely troubled institutions, the Board has testified before Congress in support of amendments to the emergency provisions of the Garn-St Germain Act that permit interstate acquisitions of failing institutions that exceed $500 million in total assets. We believe that two changes should be made in these provisions. First, emergency interstate acquisitions should be allowed without requiring that the troubled institutions actually be closed; and, second, the size cut-off of $500 million should be reduced or eliminated to provide for emergency interstate acquisitions of smaller institutions if an appropriate in-state merger cannot be arranged.

Notwithstanding the desirability of these improvements, we believe the bidding process has been generally successful in locating purchasers for failed banks. Of the 208 banks closed during 1983, 1984, and through October 4 of this year, 182 were acquired through mergers and acquisitions by means of the bidding process. The remaining banks were liquidated because no acceptable bids were received or because the FDIC judged that to be its least cost alternative. During this period, the Federal Reserve System has taken every step possible to ensure the timely processing of bidlists and applications received in failed bank situations. Aside from the changes recommended above, we see no obvious way to bring about a fundamental improvement in a process that appears to be functioning reasonably well. We would emphasize, however, that the massive increase in bank failures has placed considerable strains on the resources of the FDIC, and on the Federal Reserve as well, so that if failures continue at their recent rate or, as seems quite possible, rise still further, costs incurred by both agencies will increase.

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Question 10: Should federal regulators be given any exemption from the burdens of the Paperwork Reduction Act? If so, when should they be exempt?

Answer: The objectives of the Paperwork Reduction Act of 1980 are to reduce the burden of government reporting and recordkeeping requirements imposed on the public. The Federal Reserve Board supports these general objectives, and has long imposed discipline on its own data collection efforts. Since 1975, the Board has had in place an internal comprehensive system of clearance procedures, and OMB's requirements were incorporated into these procedures after the implementation of the Paperwork Reduction Act. It is worthy of note that the Federal Reserve Board was the first, and only, agency to which OMB, in 1984, granted delegated authority under the Paperwork Reduction Act.

Thus, from the perspective of the Board, the Paperwork Reduction Act has not unduly constrained our collection of information. The Board has consistently reduced its annual reporting burden to meet--and often surpass--the reductions mandated by the Act over FY 1981 through FY 1983 and imposed by OMB in subsequent years. At the same time, no Federal Reserve information collection request has been turned down by OMB, and only on rare occasions has implementation been delayed. While the Board, as an independent regulatory agency, has a statutory right to override a denial of any information collection request by OMB, the override has never been used, nor have emergency procedures been invoked. Expedited treatment has been granted when requested. For these

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reasons, we do not believe there is a need for an exemption from the Act.

With increased concerns about the safety and soundness of the financial system, more information may be needed for surveillance purposes in the foreseeable future. Therefore, it is likely that annual reductions in the Board's reporting burden will no longer be possible for the next few years. Since, in the past, OMB has responded to pressing supervisory needs, at most this situation would suggest an exemption from OMB's ceilings on information collection budgets, rather than an exemption from the Act.

Finally, it should be noted that while the Board and FDIC have the right to override OMB decisions, the OCC does not. Conceivably, this anomaly could impede joint action by the three agencies. Thus, it may be appropriate to consider granting the OCC the same override powers as the other two agencies have.

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Question 11: If regulators are rarely surprised by a bank failure--isn't the answer swifter or more appropriate regulatory action rather than increased market discipline? Wouldn't giving the regulators the ability to close an institution earlier be appropriate? Should a regulator require bank management to file a confidential bank failure plan approved by its board of directors if it falls a certain percentage below its minimum capital level for a specified period of time?

Answer: It is almost always the case that regulators find out that a bank has serious problems some significant time before it fails and are thus rarely taken by surprise by such events. In these serious problem cases I believe it is far better to have the supervisory agencies manage their resolution -- either by seeing that actions are taken to restore the institution to health or by closing or arranging a transfer of ownership and control -- than it is to rely on market discipline. For in such situations market forces tend to impose a draconian form of discipline, often creating a crisis atmosphere that can complicate an orderly resolution of the problem and pose dangers of a greater or lesser degree, for other institutions and the banking system.

I have already expressed, in response to question 1, my view on the proposals for giving regulators power to close an institution "earlier." As for requiring bank management to file a confidential bank failure plan approved by its board of directors, regulators not only should, but, as I also indicated in question 1, regularly do require banking organizations whose capital is below the minimum guidelines or that are otherwise deemed to be inadequately capitalized to submit a written plan acceptable to the Federal

Reserve for achieving an appropriate level of capital within a reasonable period of time. Banking organizations that fail to meet their plans are subject to formal enforcement actions that can require (i) an immediate injection of capital, (ii) other financial adjustments or remedial steps to relieve pressure on the bank's capital position, or (iii) an immediate suspension of an officer or director when it is found necessary for the protection of the institution and its depositors.

Question 12: What percent of total bank earnings are paid in deposit insurance premiums each year? Has this percentage gone up or down over time? Is there much variance bank to bank or by size of institution?

Answer: It is our understanding that this question has also been asked of the FDIC which is in a better position than the Federal Reserve to provide the relevant facts. We thus defer to the FDIC's response.

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Question 13: There appears to be strong support for required risk-based capital - as a method of calculation of capital or as a supplement to the flat rate capital ratios. Would this necessarily lead to higher capital standards? Is there any need for legislation in this area if such risk-based standards were to be applied equally to all institutions?

Answer: The Board and other Federal agencies have taken a number of steps over the last several years to encourage banks to strengthen their capital positions, the most recent being an action earlier this year that raised capital standards for larger banking institutions. Largely as a result of these steps, bank capital ratios have been increased. At the same time, however, off-balance sheet risks of larger banking organizations have grown and their liquidity has been reduced. In light of these developments and the recognition that risk profiles of banking organizations tend to differ, we have been actively considering whether to adopt a risk-based capital measure to supplement our existing guidelines.

The need to refer to risk exposure in deciding on the appropriate level of capital a banking organization should maintain is already recognized in our existing guidelines. While these guidelines specify minimum ratios of primary capital and total capital to total assets for banking organizations, they also stress that organizations are generally expected to operate with ratios above those minimum levels and that the greater an institution's exposure to risk the higher these ratios should be. The guidelines, however, provide no specific direction as to the

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amount of additional capital required to compensate for greater risk exposure or as to the approach that should be followed to gage the degree of risk exposure of a banking organization. A risk-based capital measure would provide formal guidance on these questions and thus help to achieve a better alignment between the risk-profiles of banking organizations and their required capital positions.

Until a good deal of experience with a risk-based capital measure is gained, however, we would contemplate that it would serve as a supplement to, rather than a substitute for, our existing guidelines in judging the adequacy of an individual institution's capital. Such a measure would also serve the added objective of moving U.S. capital policies more into line with those of the other major industrial countries.

Whether the risk-based measures would lead to higher capital requirements for any individual bank would depend on its risk profile and the extent to which its current capital position properly reflects that profile. If it does then the bank will have to make little if any adjustment to its capital position.

We believe that existing statutory authority is sufficient to enable us and the other banking agencies to adopt reasonably uniform risk-based capital standards for all commercial banking organizations.

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Question 14: In 1981 and 1982, the banks and thrifts were suffering from disintermediation--their better customers were flocking to money market funds in droves. Now the concern seems to be that the higher quality loan customers are able to fill their needs elsewhere. The banks point to commercial paper, and the securitization of their loan portfolio. They claim that this trend is being caused in part by their capital ratios and reserve requirements. What is your view? What recommendations do you have for us in this area?

Answer: Competition in financial markets continuously places varying degrees of pressure on intermediaries to offer the public higher yields on deposits and other conveniences while pressing them to lend to their customers at lower rates on better terms and conditions. Profit margins, then, are always under assault to a greater or lesser degree.

In recent years, however, increasing refinements in telecommunications and other technologies have tended to accentuate these pressures by encouraging a further integration of domestic and world financial markets. Reflecting these developments, non-bank financial firms and nonfinancial firms have found ways to offer the investing public opportunities to acquire assets that are close substitutes for bank deposits and to provide alternative, relatively low cost sources of financing for some of the traditional loan customers of banks. In addition, competition among banks in the United States and foreign banks has tended to intensify.

In considering the role that the public policy treatment of banks is playing in this process, it is important to note that it results in advantages as well as disadvantages for banks.

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Because of Federal deposit insurance and federal supervision, for example, banks are able to operate with lower capital ratios than many other firms--e.g., finance companies and nonfinancial corporations--and are able to borrow at relatively low rates.

Nonetheless, public policy should be sensitive to disadvantages imposed on banking organizations and be prepared to reconsider positions on specific issues from time to time to assure that they continue to be consistent with the public interest. For example, we continue to support the payment of interest on required reserves, which will require congressional action. For some time the Board has recognized that our present reserve requirement structure--so important for monetary control and prudent banking--places our nation's depository institutions at some competitive disadvantage vis-a-vis other lenders, both foreign banks lending from off-shore and all non-depository lenders. While the impact of these requirements is comparatively small, we believe it should be eliminated.

Still another action that should be taken is for the Congress to enact laws that will prevent the unwarranted encroachment by nonbanking organizations (nonbank banks) into activities that traditionally have been, and properly should continue to be, the province of banks. Beyond that, I believe U.S. supervisory agencies should continue working with our foreign counterparts to promote world capital standards that will at once promote the safety of banking institutions and the world banking system and establish a more level playing field on which these institutions can compete.

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In requiring banks to maintain adequate capital, we realize that they may not be able to offer terms to certain borrowers that are as attractive as these borrowers can obtain in the open market and still earn an acceptable rate of return on their capital. In these situations, however, we see no advantage to be gained by reducing capital below prudent levels in the attempt to compensate for deficient profit margins. It makes no sense for a bank to be overly aggressive in seeking to maintain business today only to find itself in jeopardy tomorrow because of these unsound practices.

I would note that an important source of the competition that has tended to cause bank profit margins to narrow has come from within the banking system. Thus, if banks generally decide not to take on business that does not provide an acceptable return on capital when it is maintained at adequate levels, profit margins on that business will tend to rise, perhaps reaching in some cases a point at which an acceptable rate of return can be earned on an adequate capital position.

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Question 15: With regard to the concern that some states may have expanded banks' product authorities beyond what may be prudent, can this issue be dealt with by giving the federal insurance agencies the authority to require a prudent level of capital to support that activity in order to maintain insurance--rather than giving any federal agency the authority to override a state legislature? In other words, wouldn't the adoption of risk-based capital standards go a long way toward solving this problem?

Answer: The principle that banking organizations subject to relatively high risk exposure should hold more capital has long been recognized and, as indicated in previous answers, is built into the existing capital standards of Federal regulatory agencies. The Federal Reserve, for example, has stressed that it considers the capital ratios specified in its present guidelines as minimum ratios and that banking organizations should maintain capital above these levels commensurate with the degree of their risk exposure. In addition, the federal banking agencies are endeavoring to develop risk-based capital standards--which would more formally specify the degree to which greater capital should be held to compensate for higher risk exposure--to serve as a supplement for the basic capital standards. We believe such standards--if a practical approach can be developed--would be desirable for bank holding companies as well as banks and that the Federal Reserve and the OCC should have a role in establishing them along with the insuring agencies.

If the Congress believes that risk-based insurance premiums are a necessary tool for the federal insurance agencies,

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premium adjustments could be made in accordance with the risks inherent in expanded banking activities authorized by the states. But, as the question indicates, there are certain activities which are so risky that they go beyond the limit of what is prudent for a banking institution to engage in. In such cases, it would appear that neither risk-based capital nor risk-based premiums are an adequate response; rather, the appropriate approach is to prohibit such activities.

I would emphasize that I do not see this matter as a state's rights issue. The Federal government has long been recognized to have the power and the responsibility to establish proper standards for the operation of banking organizations and thus it can and should continue to exercise those powers and meet those responsibilities. There is need then to enact legislation to prohibit banking institutions from engaging in certain activities or that assigns powers to Federal agencies to impose appropriate guidelines for permitted activities.

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Question 16: Mr. Issac has stated that a significant number of bank failures are caused by fraud. Other than increased enforcement actions which are being taken by the federal agencies aren't Mr. Homan (Former Senior Deputy Comptroller for Bank Supervision, Office of the Comptroller of the Currency) and Mr. Ryan (Former Director, Division of Banking Supervision and Regulation, Federal Reserve System) right as to the importance of the ON-SITE exam to ascertain the integrity of the numbers being generated and the lack of fraud? If so, does the decrease in on-site examinations bring with it an increase in the risk of fraud? If so, how can this be corrected?

Answer: We agree with Messrs. Homan and Ryan. The on-site examination is an extremely critical component of the supervisory process, and provides one of the most important vehicles for detecting problems at an early stage. The on-site review by a bank examiner enables the supervisory agencies to evaluate, among other things: the accuracy and integrity of the financial data being reported by the bank; the quality of management and of internal systems and controls; and the condition of the bank's loans, investments and credit files. While fraud, in particular, is often difficult to uncover, an on-site presence vastly increases the banking agencies' ability to detect and, we believe, deter questionable or illegal practices.

For this reason, the Federal Reserve has recently adopted a policy which increases the frequency and scope of on-site examinations. This policy, a copy of which is attached, is designed to increase the frequency of on-site examinations of State member banks from every 18 months to at least annually, as well as increase the presence of the Federal Reserve in larger

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and weaker banking organizations. We believe this policy, together with plans to improve our training and our ability to hire and retain qualified experienced examiners, will strengthen the on-site examination process and improve our ability to detect supervisory problems, including fraud, in a timely manner.

Implementation of this policy will obviously result in a significant increase in our costs. We believe that increase to be warranted, however, given the many problems clearly in evidence in the banking system, as well as the unsettled conditions in a number of sectors of the economy.

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Attachment to Question 16

POLICY FOR FREQUENCY AND SCOPE OF EXAMINATIONS OF STATE MEMBER BANKS AND INSPECTIONS OF BANK HOLDING COMPANIES

This policy calls for a general increase in the frequency of examinations of state member banks and inspections of bank holding companies. The objectives sought are (a) to help prevent the development of problems at banking institutions and (b) to make more effective the Federal Reserve's ability to identify and resolve problems that develop nonetheless.

The policy requires that, in general, banking organizations for which the Federal Reserve is primary supervisor are to be examined/inspected at least annually, with the largest of such organizations and those with significant problems to be examined/inspected semi-annually. As an exception to the general rule, small "shell" holding companies with no known problems and low levels of debt relative to the book value of their subsidiary bank's stock may be inspected on a much more limited basis. Tables presenting these frequency and scope requirements are attached.

Federal Reserve Banks are to intensify their involvement in the examination/inspection of large organizations and those with significant problems. Greater reliance is to be placed on state examinations/inspections in the case of smaller organizations. If a state lacks the resources to conduct examinations/inspections in accordance with the specifications of

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this policy or is unwilling to do so, or, in the case of holding companies, lacks authority, the Federal Reserve Banks will conduct the examinations/inspections to the extent needed to meet the specifications. 1/ In addition, if a state member bank or bank holding company indicates its wish to be examined/inspected by its Federal Reserve Bank, that wish should be honored.

REQUIREMENTS FOR STATE MEMBER BANK EXAMINATIONS

No Identified Problems or Special Characteristics

Multinational state member banks and all others with assets greater than $10 billion will be subject to a full-scope examination annually. In addition, a limited-scope or targeted examination 2/ should be scheduled annually for each of these banks. If, however, a bank's financial condition is judged to be clearly satisfactory--based on its last full-scope examination, the findings of the Federal Reserve's surveillance system 3/ and other sources of information--the Reserve Bank may waive the limited-

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1/ It is suggested that Reserve Banks will need to exercise some flexibility when implementing the examination requirements in order to achieve operational efficiencies and appropriate coordination with state banking departments.

2/ A limited-scope examination will review all areas of activity covered by a full-scope examination, but less intensively. Targeted examinations will focus intensively on one or two activities.

3/ Refers to the Federal Financial Institutions Examination Council approved Uniform Bank Surveillance Screen for use by the bank regulatory agencies to identify on an early warning basis those banks in need of special supervisory attention.

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scope or targeted examination. Each of the required examinations should be conducted by the Federal Reserve Bank independently or jointly with the state; these banks should no longer be examined under an Alternate Year Examination Program (AEP).

Banks with total assets between $500 million and $10 billion will be subject to an annual full-scope examination to be conducted either by the Federal Reserve Bank independently or jointly with the state, or by the state alone on an every-other year basis under an AEP. Limited-scope or targeted examinations, between annual full-scope examinations, are to be conducted, if deemed necessary by the Reserve Bank.

Banks with assets between $100 million and $500 million must also be examined annually on a full-scope basis. Such examinations by the state in two out of every three years will be acceptable under an AEP. Additional limited-scope or targeted examinations will be conducted when deemed necessary by the Reserve Bank.

Banks with assets of less than $100 million are also to be subject to an annual full-scope examination. It will be acceptable for the Reserve Bank to limit its involvement in such examinations to once every four years, if the state conducts annual examinations under an AEP in the other three years. Additional limited-scope or targeted examinations will be conducted when deemed necessary by the Reserve Bank.

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Banks Requiring Special Supervisory Attention

Banks receiving a CAMEL 1/ composite rating of 4 or 5 on an examination must be examined on a twice-a-year basis thereafter until the problem is resolved; at least one of these two must be a full-scope examination. If a bank has total assets in excess of $500 million, both examinations must be conducted by its Federal Reserve Bank, independently or jointly with the state. If a bank has total assets of less than $500 million, an examination conducted independently by the state on an every other-time basis will be acceptable.

All banks rated a CAMEL composite 3 on their last examination are to have an annual full-scope examination conducted by the Federal Reserve, independently or jointly with the state. In addition, a limited-scope or targeted examination of composite 3-rated banks with total assets greater than $500 million must be conducted during the year by the Federal Reserve, independently or jointly with the state.

Banks With Special Characteristics

State chartered banks applying for membership in the Federal Reserve System are to receive a full-scope examination by the Federal Reserve before membership is granted. Particular

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1/ CAMEL refers to the rating system used by the federal supervisory agencies to assess the financial condition of commercial banks (F.R.R.S. 3-1575).

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attention is to be given in these examinations to the quality of assets and the adequacy of capital.

Similarly, a full-scope examination by the Federal Reserve, independently or jointly with the state, will be required within 12 months following (1) the formation of a de novo state member bank or (2) the change in control of a state member bank.

Banks which in the judgment of the Reserve Bank fail the surveillance screen or which the Reserve Bank, on the basis of other information, has reason to believe may have significant problems, are to receive an in-depth, off-site review to determine whether an on-site examination should be conducted by the Federal Reserve, independently or jointly with the state.

REQUIREMENTS FOR BANK HOLDING COMPANY INSPECTIONS

Bank Holding Companies With No Identified Problems or Special Characteristics

Multinational bank holding companies and all others with consolidated assets over $10 billion are to receive a full-scope inspection annually to be coordinated with the examination of the lead bank to the extent possible. Although the inspection of the holding company and the examination of the lead bank need not be commenced simultaneously, they should overlap and rely on financial statements as of the same date, if possible, in order to facilitate the analysis and the presentation of findings to management and directors. A limited-scope or targeted inspection of these companies is also to be conducted between the annual full-scope inspections, the precise

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timing to be determined by off-site surveillance reports and by opportunities to coordinate with the examination of the lead bank. The requirement for a limited-scope or targeted inspection may be waived by the Reserve Bank if, on the basis of the findings of the last full-scope inspection and of the surveillance system, the institution is judged to be in satisfactory condition.

Complex bank holding companies (defined as companies with nonbank subsidiaries that extend a material amount of credit or companies whose parent has a material amount of debt outstanding to the general public) with consolidated assets between $500 million and $10 billion receive a full-scope inspection annually. Noncomplex "shell" organizations in this size group are to receive a limited-scope inspection every two years. These inspections should be conducted, to the extent possible, in coordination with the examination of the lead bank. All bank holding companies in this size group should be subject to additional limited-scope or targeted inspections when the Reserve Bank has information that suggests the institution may be developing significant problems.

Complex bank holding companies with consolidated assets between $150 million and $500 million are to receive an annual full-scope inspection. Noncomplex shell bank holding companies in this size group are to receive a limited-scope inspection on a once in three year basis.

Inspection frequency for bank holding companies with consolidated assets of less than $150 million is to be determined

by their structural characteristics and their debt levels. Complex bank holding companies are to receive a full-scope inspection every other year. Noncomplex shell companies with parent debt exceeding the book value of the stock of the company's bank (or banks) should be inspected every other year. These inspections may be either full-scope, limited-scope or targeted as deemed appropriate.

Noncomplex shell companies (with consolidated assets less than $150 million) with a ratio of parent debt to the book value of the stock of the company's bank (or banks) of less than 100 percent will be inspected on a sample basis: a 20 percent sample will be drawn of companies with a ratio between 75 to 100 percent for inspection each year; a 10 percent sample will be drawn of companies with a ratio below 75 percent for inspection each year. These inspections may be either full-scope, limited-scope or targeted as deemed necessary. (NOTE: Companies that received a BOPEC[1/] composite rating of 3, 4, or 5 or failed a surveillance screen will not be included in the population from which samples are to be drawn and should be inspected in accordance with the frequency requirements set forth below.)

In addition to the above inspection requirements, in the case of companies with less than $150 million in consolidated assets, primary federal and state bank supervisors are to be asked to review, during their examination of a bank, any significant

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1/ BOPEC refers to the Federal Reserve's rating system for bank holding companies (F.R.R.S. 4-865).

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dealings between the bank and the holding company and to report such findings along with any other relevant information on the health of the organization to the Federal Reserve. (A short form will be provided to make such reports to the Federal Reserve.) The Federal Reserve Banks will review this and other information to determine whether an inspection of the holding company should be conducted. Further, the Federal Reserve will be prepared to inspect any of these small bank holding companies--as well as any larger holding company--at the request of the bank's primary supervisor.

Bank Holding Companies Requiring Special Supervisory Attention

Inspection frequency of bank holding companies requiring special supervisory attention is to be determined by both the size and complexity of the organization. The most intensive frequency requirements are directed at bank holding companies rated BOPEC composite 4 or 5, or whose lead bank subsidiary has been rated CAMEL composite 4 or 5. All bank holding companies so rated with consolidated assets over $500 million are to receive an annual full-scope inspection and a limited-scope or targeted inspection during the interval between full-scope inspections. The same requirements apply to complex bank holding companies with assets between $150 million and $500 million. To the extent possible, inspections of these 4 and 5 rated bank holding companies are to be coordinated with the examination of the lead bank subsidiary. Noncomplex bank holding companies with assets of $500 million or less are to receive an annual inspection whose

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scope may be determined by the Reserve Bank based upon the nature of the companies' problems.1/ Complex holding companies with assets under $150 million are to receive a full-scope inspection annually.

Bank holding companies rated composite 3 with consolidated assets over $500 million are subject to the same requirements as those rated 4 or 5. Bank holding companies with consolidated assets between $150 million and $500 million with complex structures are to receive an annual full-scope inspection; those with noncomplex structures are to receive an annual inspection, the scope of which is to be determined by the Reserve Bank. Complex bank holding companies with assets under $150 should receive a full-scope inspection annually; noncomplex bank holding companies with assets less than $150 million are to be inspected every other year. The type of inspection for these small noncomplex companies may be determined by the Reserve Bank.1/

Bank Holding Companies with Special Characteristics

Bank holding companies formed to acquire an existing bank are to be inspected to determine their compliance with Federal Reserve regulation and the extent to which they have fulfilled commitments the Board of Governors required of the organization in approving its application. Such inspections should be conducted between the 6th and 13th month after the acquisition; their scope is to be determined by the Reserve

1/ Reserve Banks may, under appropriate circumstances, enlist the assistance of the primary bank regulator in conducting these inspections.

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Bank. If information available to the Reserve Bank--the most recent examination of the bank, the most recent FR Y-6 and FR Y-9 reports from the holding company and other pertinent information--indicate that (a) the condition of the bank and bank holding company is satisfactory, (b) the bank holding company is fulfilling its commitments to the Board of Governors, and (c) the ratio of the parent's debt to the book value of the subsidiary bank (or banks) is less than 75 percent then, at the Reserve Bank's discretion the inspection may be delayed as long as 36 months after the formation. Moreover, the requirement for an inspection may be waived in the case of a bank holding company whose bank subsidary has less than $50 million in total assets, if in the Reserve Bank's judgment, (a) the holding company's financial condition is satisfactory, and its commitments to the Board of Governors are being fulfilled, and (b) the ratio of the holding company's debt to the book value of the subsidiary bank (or banks) is less than 75 percent.

Bank holding companies that have undergone a change in control and de novo bank holding companies organized to acquire de novo banks, are to receive a full-scope inspection within 12 months following the change in control or formation. A limited-scope or targeted inspection may be conducted in lieu of the full-scope inspection, if, in the judgment of the Reserve Bank, the financial condition of the holding company appears satisfactory.

In those cases where bank holding companies fail the surveillance screen or where other information suggests the company has experienced an adverse development, an in-depth off site review will be made to determine the need for a limited-scope or targeted inspection.

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TABLE

FREQUENCY AND SCOPE OF EXAMINATIONS OF STATE MEMBER BANKS

Asset Size / Rating	$10 billion +	$500 mm - $10 billion	$100 mm - $500 mm	Less than $100 mm
1 or 2	Full-scope required annually (FR or Joint). Limited-scope or targeted presumed annually (FR or Joint).	Full-scope required annually (FR, Joint or AEP on basis of every other year). Limited-scope or targeted when needed.	Full-scope required annually (FR,Joint or AEP on basis of every three years). Limited-scope or targeted when needed.	Full-scope required annually (FR,Joint or AEP on basis of every four years). Limited-scope or targeted when needed.
3	Full-scope required annually (FR or Joint). Annual limited-scope or targeted also required (FR or Joint).		Full-scope required annually (FR or Joint). Limited-scope or targeted when needed.	
4 or 5	Exam required every six months, one must be full-scope, one may be limited-scope or targeted. (Both must be FR or Joint.)		Exam required every six months, one must be full-scope, one may be limited-scope or targeted. (At least one must be FR or Joint.)	

Special Characteristics:
1. New member banks: full-scope FR exam required before membership granted.
2. Change in control or de novo member bank: full-scope FR exam required within 12 months.
3. Banks that fail surveillance screen or for which other significant adverse information is received: triggers in-depth, off-site review to determine need for examination to be conducted by FR or jointly with state.

Notes:
1. A full-scope examination covers all areas of interest to the Federal Reserve in depth; a limited-scope examination will review all areas of activity covered by a full-scope examination, but less intensively; targeted examinations will focus intensively on one or two activities.
2. The Alternate-year Examination Program (AEP) provides for Federal Reserve and state examinations of state member banks on alternating periods.
3. Joint examinations are conducted by the Federal Reserve and the state, simultaneously, with one joint report being prepared.

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TABLE 2

FREQUENCY AND SCOPE OF INSPECTIONS OF BANK HOLDING COMPANIES

Asset Size	$10 billion +	$500 mm to $10 billion		$150 mm - $500 mm		Less than $150 mm	
Rating		Complex	Noncomplex	Complex	Noncomplex	Complex	See Note #4 Noncomplex
1 or 2	Full-scope required annually. Additional limited-scope or targeted presumed annually.	Full-scope required annually Limited-scope or targeted when needed.	Limited-scope required every two years. Additional limited-scope or targeted when needed.	Full-scope required annually.	Limited-scope required every 3 years.	Full-scope required every other year.	See Note #3
3	Full-scope required annually. One limited-scope or targeted also required annually.				Inspection required annually, may be limited-scope or targeted.	Full-scope inspection required annually.	Inspection required every other year.
4 or 5				Full-scope required annually; one limited-scope or targeted also required annually.	Inspection required annually.	Full-scope inspection required annually.	Inspection required annually.

Special Characteristics:

1. BHCs formed to acquire going concerns: inspection to be conducted between the 6th and 18th months of operation; or within 36 months under specific conditions; or waived if under $50 mm with specific conditions.
2. Change in control or de novo BHCs: inspection required within 12 months.
3. BHCs that fail surveillance screen or for which other significant adverse information is received: triggers in-depth off-site review to evaluate need for limited-scope or targeted inspection.

Notes:

1. A full-scope inspection covers all areas of interest to the Federal Reserve in depth; a limited-scope inspection will review all areas of activity covered by a full-scope inspection, but less intensively; targeted inspections will focus intensively on one or two activities.
2. A complex BHC is defined as one with material credit-extending nonbank subsidiaries or debt outstanding to the general public. A noncomplex BHC is one without credit-extending subsidiaries and without public debt.
3. The frequency of inspection of noncomplex "shell" BHCs that are rated BOPEC 1 or 2 is based upon the ratio of parent debt to the book value of the bank's stock: a) if over 100 percent--inspect every other year; b) if 75-100 percent--inspect a 20 percent sample each year; c) less than 75 percent--inspect a 10 percent sample each year.
4. For small noncomplex BHC's, Reserve Banks should explore the possibility, under appropriate circumstances, of enlisting the assistance of the primary bank regulator in conducting the inspection.

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Question 17: Even though the FDIC continues to grow, how can or should we determine if the size of an insurance fund is sufficient and will continue to be sufficient?

Answer: It is our understanding that this question has been asked of the FDIC which is in a better position than the Federal Reserve to discuss issues relating to the sufficiency of the insurance fund. We thus defer to the FDIC's response.

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Question 18: In your opinion, what are the advantages and the disadvantages of risk-based capital and risk-based premiums? Should we consider one or the other or both? Why?

Answer: Risk-based capital standards and risk-based deposit insurance have important similarities and also significant differences. Regarding similarities, an objective of both approaches is to establish greater market-type inducements for reducing risk-taking by depository institutions. Other common objectives are to create a more equitable distribution between low- and high-risk banks of the public and private costs of risk-taking and to protect depositors and other creditors of a failing bank from loss. Both also share similar practical difficulties in accurately measuring bank risk-taking exposure on an ex-ante basis.

One difference between these two arrangements is that, if, say, the risk exposures of banks generally were to rise, the capital position of individual banks would be built up under risk-based capital while the deposit insurance fund of the banking system would grow under risk-based insurance. The consequence of that difference is that individual banks would be better positioned to absorb the losses resulting from their higher risk exposure -- and thus less prone to fail -- in the case of risk-based capital, while the deposit insurance fund would be better placed to deal with failures that nonetheless occur in the case of risk-based insurance.

Another difference is that risk-based capital appears to afford the supervisor more flexibility and discretion than a

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risk-based premium system. A risk-based insurance system would seem to require the insuring agency to publish a fixed schedule of fees to be charged against different levels of risk and to specify in some detail the variables to be referred to in determining these fees. Morever, there would seem to be little room to depart from relying solely on that approach in guaging the risk exposure of individual institutions or to make adjustments in either the amount, or the timing in the payment, of risk-based premiums.

In contrast, a risk-based capital standard can be based on comparatively broad categories of assets and can be designed to have the flexibility to take into account "intangibles" that are impossible to quantify but can be quite important in the overall risk profile of an institution. In addition, it would be possible to have greater discretion in establishing the timing and speed with which banking organizations would be instructed to bring their capital into conformance with the standard. Finally, given this flexibility, there would also seem to be more room for experimentation in seeking to refine an existing system.

In addition, an important aspect of introducing a risk-based capital standard is that it offers the further advantage of moving U.S capital standards into greater conformance with those of other major industrial countries.

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Question 19: On page 32 of your statement, you state "well run thrift institutions, at present interest rates, have the potential for rebuilding capital." This implies that the thrift problem should be handled. What advice do you have for the Congress in dealing with the troubled thrifts and the FSLIC? What is your view of the proposed asset management corporation?

Answer: The thrift industry, as a whole, recorded positive earnings in 1983 and again in 1984 after suffering sizable losses in 1981 and 1982. Moreover, earnings have increased substantially again this year in response to further, relatively large declines in market interest rates. Thus, there is good reason to hope that if interest rates remain near current levels most well managed thrift institutions will continue to record sizable earnings which over time will help restore reduced capital positions. That is an encouraging outlook for the core of the industry.

I do not wish to leave the impression that it will be easy for the thrift industry as a whole to work out of its troubles. Capital positions in the industry are greatly depleted and a number of years of good earnings and high earnings retention will be required to restore these positions for most associations even under relatively favorable interest rate conditions. Should interest rates rise significantly, prospects for reduction of the industry's problems would decline greatly.

Perhaps more important and certainly more pressing today, a sizable minority of institutions are in trouble because they engaged in relatively risky activities with insufficient attention

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to controlling those risks. Some of these institutions will prove difficult to salvage even if the interest rate climate remains favorable for more conservatively and traditionally operated thrifts. Thus, I believe that larger premium payments, as required by the Federal Home Loan Bank Board's special premium assessments, may continue to be necessary and that the FHLBB should have ample authority to limit unsound activities of thrift institutions.

Regarding the asset management corporation, which the Federal Home Loan Bank Board recently announced it was establishing, it is my understanding that the purpose of this corporation is to facilitate the liquidation of assets acquired by the FSLIC from insolvent institutions and that risks of loss on these assets remain with the FSLIC. Provided that is so and other safeguards of the public interest are respected, I am in favor of this corporation because I believe it can play a useful role in assisting the thrift industry to work out of its problems.

Chairman Volcker subsequently submitted the following response to a written question from Senator Gorton in connection with the hearing held before the Senate Banking Committee on September 11, 1985:

Question 20: Recently a growing number of witnesses have argued that the commercial banking industry is at a long term disadvantage vis-a-vis the securities industry, because it is possible to offer cheaper financing via the securities route than through bank loans, by economizing on capital. Yesterday Mr. Cairns of the ABA argued that this was the fundamental long-term problem facing the banking industry.

But in your testimony you indicate that you are considering increasing capital requirements further for banks, despite the fact that this would exacerbate this problem. Do you dismiss the bankers' contention that this is a serious and fundamental long-term problem for them?

Answer: The basic health and stability of our economy vitally depends on the banking system functioning in an efficient and safe and sound manner. To promote this end, our nation has long sought to establish a structure of rules and regulations to govern the activities and practices of banking institutions. The capital standards that the banking agencies have put in place in recent years are an important element in that structure. Long experience demonstrates the wisdom of banks, as well as other businesses, maintaining an adequate capital base to enable them to weather unforeseen adverse developments and, in the event of insolvency, to protect depositors, other creditors and the deposit insurance fund against loss.

I recognize that in meeting these standards banks may find that they cannot profitably compete for the business of certain borrowers, particularly those with the highest credit

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standing. In such cases, however, I do not believe it makes good sense for banks to attempt to obtain this business by shaving their margins (between interest rates charged on loans and paid on deposits and other liabilities) to unduly low levels and attempt to compensate for the impact of these low margins on returns on capital by reducing capital below prudent levels. Such an approach will tend to lead to capital positions becoming ever more eroded in an endeavor to compensate for ever-narrowing margins.

In short, my view is that if banks cannot compete for certain business in an effective and safe and sound manner, they should forego that business. At the same time, however, I believe it important to eliminate situations in which banks are required to meet prudential standards in order to promote the public good while, at the same time, thrift institutions and certain nonbank entities that have access to the payments system and take insured deposits engage in such businesses on a less regulated basis that does not require the same standards to be met. That makes no sense from the perspective of consistent public policy; nor is it fair to the banking system. This is one reason that I have been urging the Congress to take actions necessary to stop the unwarranted and unfair operations of nonbank banks and to deal with the non-thrift thrift problem.

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Chairman Volcker subsequently submitted the following in response to written questions from Senator Riegle in connection with the hearing held on September 11, 1985:

QUESTION 1: The Committee heard testimony earlier this year that access to the payments system by unregulated holding companies (companies that are not regulated as bank holding companies or multiple savings and loan holding companies) poses significant risk to the safety and soundness of the nation's financial system. Do you agree?

ANSWER. Access to the payments system by unregulated holding companies, i.e., holding companies that are not subject to regulation under the Bank Holding Company Act or as multiple savings and loan holding companies, can pose risks to other participants in the payments system. While certain risks are inherently present from access to the payments system by any business or institution, part of the purpose of regulating banks and bank holding companies is to minimize and control those risks.

Regulated holding companies that own depository institutions, and thereby have access to the payments system, generally are subject to restrictions on their business activities in order to limit the exposure of their subsidiary depository institutions to risks arising from the commercial activity of the holding company and to prevent their exploitation in support of that activity. Further, transactions between regulated holding companies and their subsidiary depository institutions are subject to review by the agency responsible for regulating the regulated holding company. Consequently, subsidiaries of regulated holding companies are exposed to less

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risk of failure of the parent company because the risk of failure of the parent is reduced by the restrictions on its business activity and its inspection and supervision by the regulatory agency.

In the case of unregulated holding companies, these protections do not exist. In some cases, the subsidiary depository institution may be established with a principal purpose of processing payments for the parent. Because of the greater risk attendant on the operations of the unregulated parent and its relations with the subsidiary depository institution, the depository institution is less likely to exercise independent credit judgments concerning its parent and may be under pressure to process payments on behalf of the unregulated parent company that would result in an overdraft to the parent's account that the parent is unable to cover.

An overdraft to a depository institution's account could result in the failure of the depository institution holding the account and consequent harm to the institution's depositors, the insurance funds established for the protection of depositors, a Reserve Bank or correspondent bank processing payments for the subsidiary depository institution as well as other participants in the payments system that may have entered into transactions with the depository institution.

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This is not to say that access to the payments system by any particular subsidiary of an unregulated holding company is necessarily riskier than access by any particular subsidiary of a regulated holding company. The point is that the nature of the relationship between unregulated holding companies and their subsidiaries generally creates potential risks that are present to a far lesser degree in the relationship between regulated holding companies and their subsidiaries. These risks translate into increased risks for other participants in the payments system and therefore have clear implications for the safety of the system as a whole. It was these potential risks that, among other purposes, the Congress sought to avoid in enacting the Bank Holding Company Act. Direct access by non-regulated holding companies would, in effect, open a broad avenue for evading the framework of the Act and the public purposes served by that Act.

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QUESTION 2: If so, should this problem be solved by prohibiting depository institutions owned by unregulated companies from accessing the payments system on their behalf?

ANSWER. Prohibiting depository institutions owned by unregulated holding companies from accessing the payments system on behalf of the unregulated parent company would largely eliminate the risks to participants in the payments system arising from failure of the depository institution due to payments practices abuses by the parent. The Board has supported limited exceptions from the definition of bank in the Bank Holding Company Act for trust companies on the condition that such institutions do not obtain payment services from the Federal Reserve. The Board has also supported a provision that would prevent an insured thrift institution from providing services to an affiliate engaged in activities that are impermissible for multiple savings and loan holding companies.

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INSOLVENCY AND RISK-TAKING IN THE THRIFT INDUSTRY: IMPLICATIONS FOR THE FUTURE

by

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INSOLVENCY AND RISK-TAKING IN THE THRIFT INDUSTRY: IMPLICATIONS FOR THE FUTURE*

I. Introduction

Since 1980, 510 thrift institutions insured by the Federal Savings and Loan Insurance Corporation (FSLIC) have failed.[1] Although the number of failures has declined since 1982 when a record 252 institutions failed, there were approximately 434 institutions in 1984 with zero or negative net worth and approximately 856 institutions with net worth greater than zero but less than or equal to three percent.[2] Given the large number of recent insolvencies, the FSLIC's reserves in 1984 declined significantly for the first time in its history to $5.9 billion.[3] The Federal Home Loan Bank Board (Bank Board), as operating head of the FSLIC, has sought to increase the FSLIC's reserves to deal with future as well as the recent large number of insolvencies. The Bank Board has also adopted significant regulatory changes designed to improve the condition of the industry.

The purpose of this paper is twofold. First, we put the problems facing the thrift industry, the Bank Board, and the FSLIC into historical perspective. This involves a discussion of the development of federal deposit insurance and regulation of depository institutions as well as a discussion of the causes of the recent difficulties faced by thrift institutions and the policy responses to those problems.[4] Second, we discuss the effect of the failures on the risk-taking behavior of thrift institutions and the Bank Board's policy responses to risk-taking. We conclude with some suggestions about what may be done to respond to the large and growing number of in-

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* The term "thrift industry" denotes savings and loan associations and savings banks, both federally and state-chartered, that are insured by the FSLIC.

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solvent institutions with an economic incentive to pursue extremely risky portfolio opportunities.

II. Development of Federal Deposit Insurance and Regulation of Depository Institutions

The contemporary regulatory system for depository institutions began with the creation of federal deposit insurance in 1933 for commercial banks and in 1934 for thrift institutions. Until that time, the Federal Reserve System, established in 1913 and acting as lender of last resort, was supposed to provide sufficient liquidity to prevent widespread runs on depository institutions. The Great Depression, however, demonstrated that the existence of the Federal Reserve was not sufficient to prevent runs.[5] To reduce further the likelihood of bank runs, the Federal Deposit Insurance Corporation (FDIC) was established in 1933 and the FSLIC was created in 1934.

The Federal Reserve as lender of last resort, the FDIC, and the FSLIC were not created to prevent runs *per se*. If they had been created to prevent individual bank runs, for example, they would merely have been protecting depository institutions against failure. They were instead created primarily to protect against the potential externalities, or larger social costs, created by widespread runs. The costs from such runs result from a breakdown in the intermediation function, a disruption of the payments system, and a contraction of the money supply. It is primarily to protect against these events that the Federal Reserve and the deposit insurance funds were created.[6]

In addition to the establishment of the FDIC and the FSLIC, the experience of the Great Depression led to regulations restricting the asset and liability powers of commercial banks and thrift institutions. The restrictions limited the rates of interest that could be paid on assets and liabili-

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ties and restricted competition among financial institutions of the same type as well as among different types of institutions. Hence, government-provided deposit insurance was designed to reduce the likelihood and consequences of widespread depository-institution failures through runs, while government regulations limiting activities and competition of the institutions were designed to reduce the likelihood of failures through excessive risk-taking and competition.

Government regulation was also designed to limit social costs by reducing the adverse incentives created by deposit insurance. The provision of government insurance at a flat or non-risk-adjusted rate--as has been done since 1933--creates a problem referred to as moral hazard. Financial institutions have an incentive to opt for a higher-risk portfolio than they would if the price of the insurance were positively related to portfolio risk.[7] At the same time, insured depositors have no economic incentive to monitor the activities of the institution since their deposits are insured. This means that with deposit insurance, the government attempts to reduce the potential social costs caused by runs, but at the cost of increased portfolio risk due to moral hazard and thus a greater likelihood of failure. Portfolio restrictions and other regulatory requirements are justified in this situation as a way to reduce this moral hazard.

Until the 1980s, the financial system, in general, functioned as its designers intended. Commercial banks played a distinct role in providing transactions balances or demand deposits without significant bank failures. At the same time, thrift institutions played a distinct role in providing savings deposits and thus funds for housing, also without significant failures. Beginning in the late 1970s, however, technological change, financial service innovation, changed economic conditions, and deregulation

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developed with unprecedented speed and rapidly eroded the differences among firms providing hitherto distinct financial services. Some thrift institutions began offering checkable deposits, for example, and those with state charters received expanded asset powers in several states. The result was increased competition between commercial banks and thrift institutions. At the same time, commercial banks and thrift institutions began competing more with other types of financial firms providing interest-earning deposits and checkable-type accounts. Furthermore, the first nonbank bank was established in California in 1980, resulting in de facto if not de jure interstate banking.[8]

Concurrent with these developments, the Federal Reserve Board in October 1979 announced a change in its operating procedures. Monetary aggregates were for a time given higher priority than interest rates in guiding monetary policy. Following this change, however, the money stock declined rapidly and unevenly. Then in March 1980, the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) was passed. The Act phases out deposit-rate ceilings by 1986, authorized interest-bearing checking accounts for individuals and non-profit customers of thrift institutions, and authorized federally chartered savings and loan associations to make commercial real estate loans, consumer loans, and investments in commercial paper and corporate debt securities (up to 20 percent of assets). These developments contributed to higher and more variable interest rates and increased competition among financial firms, which in turn contributed to the problems of the thrift industry in the early 1980s.

III. Thrift-Institution Failures in the 1980s

Table 1 presents the extraordinary number of thrift-institution failures during the period 1980 through 1984.[9] Before 1980, the largest number of

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Table 1

FSLIC-INSURED FAILURES: 1980-1984[a]

Year	Number of Failures (1)	Number of Insured Institutions (2)	Number of Insured Accts. of Failed Institutions (3)	Number of Insured Accts. for all Institutions (Thousands) (4)	Assets of Failed Institutions (Thousands) (5)	Assets of all Institutions (Millions) (6)	Percent of Institutions that Failed (7) = (1)/(2)	Percent of Insured Accts. Held by Failed Institutions (8) = (3)/(4)	Percent of Assets Held by Failed Institutions (9) = (5)/(6)
1980	35	4,002	161,702	92,189	2,947,877	618,466	0.87	0.18	0.48
1981	81	3,779	1,860,233	98,740	15,057,057	651,068	2.14	1.88	2.31
1982	252	3,343	2,817,742	98,936	46,836,869	692,663	7.54	2.85	6.76
1983	101	3,040	1,995,031	103,214	15,939,476	819,168	3.32	1.93	1.95
1984[b]	41	3,167	N/A	108,738	6,799,786	978,514	1.29	N/A	0.69

[a] Failure is defined to be a case requiring supervisory action or FSLIC assistance.

[b] Preliminary year-end figures.

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failures in any single year was 13 in 1941. The 510 failures that occurred from 1980 through 1984 accounted for over 60 percent of the attrition that has occurred among insured thrift institutions since 1980. The total decline (including all mergers) was 835 institutions--down from 4,002 institutions in 1980 to 3,167 institutions in 1984. The total assets of the failed institutions were about $87.6 billion. The number of failures peaked in 1982 when 252 FSLIC-insured institutions, representing 7.5 percent of all institutions, failed.

Even though an unprecedented number of FSLIC-insured institutions have been closed or merged by the Bank Board since 1980, the number of insolvent and nearly insolvent institutions still operating has grown. As Table 2 shows, based on Generally Accepted Accounting Principles (GAAP), the number of institutions with estimated GAAP net worth to total liabilities less than or equal to zero rose from 17 in 1980 to 434 in 1984. The operating GAAP-insolvent institutions had assets of $107.3 billion in 1984. Nearly insolvent institutions, those with estimated GAAP net worth to total liabilities between zero and three percent, also rose dramatically--from 280 in 1980 to 856 in 1984. The nearly insolvent institutions had assets of about $350 billion in 1984. The combined assets of the 1,290 GAAP-insolvent and nearly insolvent institutions represented 45 percent of all assets of FSLIC-insured institutions in 1984.

Table 2 also shows that the number of RAP-insolvent and nearly insolvent institutions has been increasing at an unprecedented rate. In 1984, 877 institutions were RAP-insolvent or nearly insolvent, holding assets of about $307 billion or 31 percent of all assets of FSLIC-insured institutions. As Table 2 shows, RAP net worth began to deviate from GAAP net worth in 1981. The divergence between the two measures arose as the Bank Board altered

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Table 2

THE GAAP AND RAP NET WORTH OF THE WEAKEST FEDERALLY INSURED THRIFT INSTITUTIONS, 1980-1984

Net-Worth Calculations Based on Regulatory Accounting Principles[a]

Year[b]	Number of Institutions NWIL ≤ 0	Assets of Institutions NWIL ≤ 0 ($ Thousands)	Percent of Total Assets	Number of Institutions 0 < NWIL ≤ .03	Assets of Institutions 0 < NWIL ≤ .03 ($ Thousands)	Percent of Total Assets
1980	17	127,001	0.02	280	35,123,008	5.82
1981	41	7,190,973	1.12	636	129,372,410	20.22
1982	80	13,056,846	1.90	791	190,865,575	27.81
1983	54	12,613,895	1.55	770	201,451,226	24.76
1984	71	12,048,402	1.23	806	294,541,283	30.11

Estimated Net-Worth Calculations Based on Generally Accepted Accounting Principles[c]

Year	Number of Institutions NWIL ≤ 0	Assets of Institutions NWIL ≤ 0 ($ Thousands)	Percent of Total Assets	Number of Institutions 0 < NWIL ≤ .03	Assets of Institutions 0 < NWIL ≤ .03 ($ Thousands)	Percent of Total Assets	Number of Institutions 0 < NWIL ≤ .05	Assets of Institutions 0 < NWIL ≤ .05 ($ Thousands)	Percent of Total Assets
1980	17	127,001	0.02	280	35,123,008	5.82	1,357	241,083,868	39.9
1981	65	17,303,469	2.70	653	126,666,356	19.80	1,814	379,804,220	59.4
1982	201	48,716,430	7.10	842	204,252,098	29.77	1,824	504,221,332	73.5
1983	287	78,906,404	9.70	883	242,667,975	29.82	1,770	555,963,440	68.3
1984	456	107,319,626	10.39	856	350,360,796	34.54	1,656	675,539,320	69.1

[a] RAP Net Worth includes: Preferred Stock; Permanent, Reserve or Guaranty Stock; Paid-In Surplus; Qualifying Mutual Capital Certificates; Income Capital/Net Worth Certificates;[1] Qualifying Subordinated Debentures;[1] Appraised Equity Capital;[1] Reserves; Undivided Profits (Retained Earnings); and Net Undistributed Income.

[1] Not included in RAP net worth 12/82.

[b] December Semiannual Data for 1980-1983 and December Quarterly Data for 1984.

[c] Estimated GAAP Net Worth includes: Preferred Stock; Permanent, Reserve, or Guaranty Stock; Paid-In Surplus, Reserves; Undivided Profits (Retained Earnings); Net Undistributed Income; Less: Deferred Net Losses (Gains) on Loans Sold;[1] Deferred Net Losses (Gains) on Other Assets Sold.[2] The data collected by the Board do not include all data needed to calculate GAAP net worth. As a result, the estimated GAAP net worth may slightly overstate or understate actual GAAP net worth.

[1] For periods prior to 1/84, deferred losses sold is an estimate.
[2] Not collected until 1/84.

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accounting for income and items allowable in RAP net worth but not allowable in GAAP net worth. Due to the accounting redefinition, the difference between the number of institutions that were insolvent by RAP accounting and the number that were insolvent by GAAP accounting grew steadily from 24 in 1981 to 363 in 1984.

In addition to altering RAP accounting for income and net worth, the Bank Board also reduced the minimum net-worth requirement from five to four percent in 1980 and then to three percent in 1982. When an institution's net worth falls below the minimum net-worth requirement, the Bank Board has substantially increased authority over the operation of the institution. Table 2 shows some of the implications of the relaxation of the net-worth requirement. In 1982, for example, 871 institutions representing about 26 percent of insured-institution's assets were at or below the minimum three percent net-worth requirement. Had the minimum net-worth requirement been five percent, 2,025 institutions representing 61 percent of insured institution's assets would have been at or below the requirement. At year-end 1984, 877 institutions representing 27 percent of total assets were at or below the three-percent requirement. If the five percent requirement had been in effect, 2,090 institutions representing 66 percent of total assets would have been at or below the requirement.

Due to two other regulatory provisions, furthermore, the minimum RAP net-worth requirement may be lower than three percent of total liabilities for some institutions. Until March 1985, when the Bank Board began phasing out the provisions, institutions could use techniques known as "five-year averaging" and "twenty-year phase in" to lower their regulatory net-worth requirement. With five-year averaging, an institution could average its past fiscal year's liabilities with the preceding four fiscal years and, thus,

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reduce the denominator in its net-worth to total liabilities calculation. With twenty-year phase in, institutions that had not reached their twentieth anniversary of insurance were permitted to multiply three percent of liabilities by a fraction, the numerator of which was the number of consecutive years of insurance and the denominator of which was twenty, in order to set their minimum net-worth requirement. Thus, for example, an institution that had insurance for only five years had a minimum net-worth requirement of (.03) (5/20)=.0075.

The deterioration of the financial condition of the thrift industry is reflected not only by the weakest thrift institutions, but also by the industry as a whole. As Table 3 shows, RAP and GAAP net worth for the industry were both 5.26 percent of assets in 1980 but declined to 3.86 and 2.87 percent, respectively, by 1984. Tangible net worth shows an even bigger decline to 0.39 percent in 1984 from 5.23 percent in 1980. Market-value net worth, however, significantly improved due to declining interest rates beginning in late 1982, but still remains negative. The improvement in market-value net worth has continued in 1985 due to the continuing fall in interest rates. Although the recent decline in interest rates represents a significant improvement over their movements in the early part of the decade, the thrift industry still has negative market-value net worth.

The large number of failures in 1982 was caused primarily by a maturity mismatch between assets and liabilities. Thrift institutions were holding relatively large amounts of long-term mortgages yielding rates of return that were not only fixed but fixed at rates below the rates paid on deposits. The decline in interest rates since then has, at least temporarily, reduced this particular problem for the thrift industry. Beginning in 1983, however, thrift institutions became increasingly hampered by poor-quality assets. The

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Table 3

TOTAL FEDERALLY INSURED
THRIFT-INSTITUTION NET WORTH: 1980-1984[a]

Year	RAP NW as a Percent of Total Assets	GAAP NW as a Percent of Total Assets	Tangible NW as a Percent of Total Assets	Market-Value NW as a Percent of Total Assets
1980	5.26	5.26	5.23	-12.47
1981	4.27	4.15	3.91	-17.32
1982	3.69	2.95	0.54	-12.03
1983	4.02	3.14	0.47	-5.64
1984	3.86	2.87	0.39	-2.74

[a]See Table 1 and Footnote 2 for an explanation of RAP and GAAP Net Worth. Tangible net worth is equal to GAAP net worth less goodwill and other intangible assets. The market value is based on yearly averages of estimated portfolio yields and market interest rates. The procedure employed is based upon a modification of Kane (forthcoming) which results in values of market-value net worth less negative than those reported by him. More detailed information pertaining to these calculations is available upon request.

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FSLIC considers two-thirds of its current cases to be primarily asset-quality problems. Interest-rate risk has for the moment abated and been replaced by credit risk as the major threat to thrift institutions.

To deal with these problems, the Bank Board and the FSLIC have taken several actions, including closing the most troubled institutions by either liquidating them or merging them with healthy institutions--frequently with financial assistance from the FSLIC. Liquidations have been rare, with only 25 in the first fifty years of the FSLIC. The reason for so few liquidations is that it has rarely been the least costly way of dealing with a failed institution. As Table 4 shows, in the 1980s the cost to the FSLIC of liquidating problem institutions was significantly greater than arranging an alternative solution, such as a merger with another institution. Despite this, there were 12 liquidations from 1980 through 1984.

Regardless of the method chosen for dealing with problem institutions, the resolution cost as a percent of assets of the failed institutions rose sharply in 1984, primarily because the cost of arranging mergers for those institutions with poor-quality assets was greater than the cost of arranging mergers for those institutions with interest-rate problems. The cost also rose because the geographic expansion of nonbank banks and other financial institutions eroded the benefits of the Bank Board's efforts, begun in 1981, to arrange mergers across state lines for troubled institutions. The expansion of nonbank banks reduced the value of acquiring a troubled institution in an interstate merger. The costs to the FSLIC of dealing with troubled institutions are expected to increase to the extent that nonbank banks and other financial institutions are permitted to expand in number and location.

Whether liquidating or arranging for mergers, the FSLIC is ultimately constrained by its reserves. As Table 5 shows, reserves of the FSLIC were

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Table 4

FEDERALLY INSURED THRIFT-INSTITUTION FAILURES
LIQUIDATION COST VS. ALTERNATIVE-SOLUTION COST:1980-1984[a]

Year	Present-Value Liquidation Cost (Thousands)	Present-Value Alternative-Solution Cost (Thousands)	Ratio of Alternative-Solution Cost to Liquidation Cost	Least Expensive Alternative as a Percent of Total Assets of Failed Institutions
1980	$ 277,465	$ 166,644	0.60	11.4
1981	3,738,562	987,835	0.26	7.3
1982	6,908,002	1,127,077	0.16	4.0
1983	3,406,775	934,739	0.27	5.7
1984	1,213,015	519,384	0.43	14.7

[a]The present-value liquidation cost and present-value alternative-solution cost are estimates that are calculated by the FSLIC in order to determine how to resolve each case. These projections are made before funds are disbursed and will usually differ from the actual cost of whichever alternative is chosen.

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$6.46 billion in 1980 and declined to $5.96 billion in 1984. As Table 5 also shows, the reserves of the FSLIC, relative to total industry assets, fell to 0.61 percent in 1984 from 1.04 percent in 1980. Insured deposits exceeded $723 billion in 1984, while the reserves of the FSLIC were only $5.9 billion. Furthermore, Table 5 shows that the FSLIC's vulnerability to sudden movements in uninsured funds has increased since 1980. The $20 billion in uninsured deposits in 1980 represented 3.2 percent of total industry assets. The figure has grown to $61 billion representing 6.2 percent of total assets.

Uninsured deposits are a portion of large certificates of deposit referred to as Jumbo CDs, which also currently have an insured portion of $100,000. When depositors want to withdraw uninsured deposits, they tend to withdraw not only the uninsured portion of the Jumbo CDs but also the insured portion. As Table 6 shows, Jumbo CDs in the thrift industry in 1984 exceeded $113 billion or nearly 12 percent of total industry assets. A significant withdrawal of Jumbo CDs could cause an industry-wide drain on liquidity.

Table 6 also indicates that a substantial portion of industry deposits are in broker-originated deposits. Broker-originated deposits tend to be garnered in insured denominations, but tend to be more mobile than other insured deposits because the deposits are made primarily by institutional investors who by comparison with individuals constantly evaluate their positions. The level of broker-originated funds is about $43 billion or 4.4 percent of total industry assets. For the industry, the combined percentage of assets represented by Jumbo CDs and broker-originated funds is 16.1 percent. In the eleventh Federal Home Loan Bank Board District, which includes California, Jumbo CDs and broker-originated deposits represent nearly one-third of total assets.

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Table 5

RISK EXPOSURE TO THE FSLIC: 1980-1984

Year	Total Assets Insured Institt. (Millions) (1)	FSLIC-Insured Deposits (Millions) (2)	Uninsured Deposits in Insured Institutions (Millions) (3)	Regulatory Net Worth Insured Institutions (Millions) (4)	FSLIC Primary & Secondary Reserves (Millions) (5)	FSLIC Reserves as a Percent of Total Assets (6)=(5)/(1)	Regulatory Net Worth as a Percent of Assets (7)=(4)/(1)	FSLIC Reserves to Insured Savings (8)=(5)/(2)	Ratio of Insured to Total Deposits (9)=(2)/[(2)+(3)]
1980	618,466	483,010	20,126	32,436	6,462.3	1.04	5.24	1.34	96.00
1981	651,068	498,100	21,837	27,572	6,301.5	0.97	4.23	1.27	95.80
1982	692,663	534,120	26,342	25,386	6,330.8	0.91	3.66	1.19	95.30
1983	819,168	626,097	44,961	32,980	6,425.4	0.78	4.03	1.03	93.30
1984	978,514	723,516	61,208	37,927	5,961.5	0.61	3.88	0.82	92.20

Note: Maximum insurance coverage was as follows for the indicated dates:

1939-49:	$ 5,000	1969-73:	$ 20,000
1950-65:	$10,000	1974-79:	$100,000 for government accounts and $ 40,000 for all other accounts
1966-68:	$15,000	1980-84:	$100,000

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Table 6

MAGNITUDE OF BROKER-ORIGINATED DEPOSITS (BOD) AND JUMBO CDS (JCD) IN FSLIC-INSURED INSTITUTIONS: 1980-1984

Year	BOD (Thousands)	BOD/TA (Percent)	JCD (Thousands)	JCD/TA (Percent)	BOD + JCD (Thousands)	(BOD+JCD)/ TA (Percent)
1980	3,860,867	.6	39,667,320	6.6	43,528,187	7.2
1981	3,251,658	.5	47,483,749	7.4	50,735,407	7.9
1982	8,134,000	1.2	55,501,790	8.1	63,635,790	9.3
1983	29,711,673	3.7	80,051,685	9.8	109,763,358	13.5
1984	42,987,890	4.4	113,480,890	11.6	156,468,780	16.1

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The ratio of FSLIC reserves to insured deposits has risen above 2.0 percent in only two years since 1934 and has averaged 1.3 percent since 1974.[10] These figures indicate that FSLIC reserves are maintained at levels that are deemed sufficient to deal with normal levels of thrift-institution insolvencies, but certainly not an extraordinarily high and costly number of insolvencies. Thus, the federal government's insurance system must ultimately be backed by the Federal Reserve and the U.S. Treasury. This explains the passage of a Joint Concurrent Resolution in March 1982 placing the "full faith and credit" of the U.S. government behind the insurance fund's liabilities. (A concurrent resolution, however, is a nonbinding resolution that only expresses the "sense" of the Congress.) If future losses swamp the FSLIC fund and Congress does indeed provide funds, this will affect both monetary and fiscal policies and, thus, the federal deficit.

Deciding when to close an institution is difficult. An institution should generally be closed when the market value of its assets declines to the market value of its liabilities. It is possible, though unlikely, that none of the FSLIC-insured institutions with negative GAAP net worth satisfies this condition. The problem for the Bank Board and the FSLIC has been to determine whether an institution is insolvent based upon market values. This is difficult because the market value of an institution is the present discounted value of all future flows of revenue and costs. Thus, at a point in time, an institution can have negative net worth but have a positive market value. Such an institution is illiquid but not market-value insolvent.

Given this difficulty, the Bank Board has treated all currently GAAP-insolvent institutions (except those that are also RAP-insolvent) as illiquid but market-value solvent, or as insolvent but not severely enough to close

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given available financial and human resources. In addition to closing many institutions, the approach taken by the Bank Board and the FSLIC to the recent insolvencies has been to provide increased liquidity through advances, to implement accounting changes that have resulted in greater regulatory net worth, to lower overall net-worth requirements (until the decision on five-year averaging and twenty-year phase in), and most recently to institute new regulations aimed at reducing risk-taking activities by institutions. These and other recent regulatory changes are summarized in Table 7.

IV. Effect of Thrift Failures from 1980 to 1984 on Risk-Taking by FSLIC-Insured Institutions and Implications for the Reform of Federal Deposit Insurance

The growing level of insolvency among FSLIC-insured institutions has created a strong incentive for risk-taking. The source of the incentive for insolvent institutions to take risk is that deposit insurance creates a "heads I win, tails you lose" situation for insolvent institutions that are allowed to continue operating.[11] Financial gains accrue primarily to owners and managers if an insolvent institution takes a significant risk that succeeds, while the deposit insurer bears most of the cost if the risk fails. These perverse effects of deposit insurance also apply to depository institutions close to insolvency. Increased risk-taking provides possible improvement and resurrection in a relatively short period of time for the owners and managers of institutions nearing insolvency.

Since 1980, the incentive for insolvent or nearly insolvent institutions to take increased risk may have been increased by the impression among FSLIC-insured institutions that only a few of the more conspicuous outliers among insolvent institutions could be closed by the Bank Board due to the limited

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TABLE 7

SIGNIFICANT REGULATORY CHANGES

1980	Depository Institutions Deregulation and Monetary Control Act (March 31, 1980)
	Florida Savings Association Act (July 1, 1980) expanded state-chartered thrift investment powers, as was done previously in Maine (1975) and Texas (1972).
	Statutory Reserve Requirement reduced from 5 percent of insured accounts to 4 percent. Minimum Net Worth set at 4 percent of liabilities.
1981	Introduction of nationwide NOW accounts.
	Institutions permitted to defer losses from the sale of assets with below-market yields.
	Federal Home Loan Bank Board liberalized its regulations regarding the conversion of federally chartered institutions from mutual to stock type of organization (April 1981).
	Qualifying Mutual Capital Certificates included as RAP net worth.
	Income Capital Certificates introduced.
	Adjustable-Rate Mortgages authorized (April 1981).
1982	Joint Concurrent Resolution (March 1982) passed, placing the "full faith and credit" of the U.S. government behind the insurance fund's liabilities.
	Garn-St Germain (October 15, 1982).
	Net Worth Certificates, Qualifying Subordinated Debentures, Appraised Equity Capital included as RAP net worth.
	State-Chartered Mutual Institutions permitted to convert to Federal Stock Charters.
	Net Worth Requirement reduced to 3 percent of liabilities; Statutory Reserve Requirement reduced to 3 percent of insured accounts.
	Money Market Deposit Account established (December 1982).
1983	California legislature passed the Nolan Bill (January 1, 1983), allowing state-chartered thrifts to broaden their investment activities.
	Super NOW accounts introduced (January 1983).
1984	No significant regulatory changes.
1985	Net Worth Regulation (March 21, 1985).
	Direct Investment Regulation (March 21, 1985).

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resources of the FSLIC. This impression was almost certainly unavoidable as early as 1981 when the FSLIC was confronted with the abrupt and staggeringly large increase in insolvent and nearly insolvent institutions without any corresponding increase in the size of the FSLIC fund. Table 8 presents some of the data that may have conveyed the impression that the FSLIC could only handle the most severe cases. Between 1980 and 1981, the assets of institutions with GAAP net worth less than or equal to three percent rose by $108.7 billion and the FSLIC fund fell slightly from $6.46 to $6.30 billion. The ratio of FSLIC reserves to the assets of FSLIC-insured institutions with GAAP net worth less than or equal to three percent fell steadily from 18.3 percent in 1980 to 1.3 percent in 1984. Between 1981 and 1984, if even a small fraction of insolvent institutions had been closed, the FSLIC fund would have been depleted. For insolvent and nearly insolvent institutions aware of this fact, the incentive to take additional risk may have been enormous.

The impression that the Bank Board was unable to close all but the weakest institutions has been strengthened by the data on the FSLIC reserves, outlays, and the costs that the FSLIC was willing to incur from 1980 through 1984. As Table 8 shows, the FSLIC primary and secondary reserves were almost constant from 1980 through 1983, and though the coverage ratio of FSLIC reserves to insured liabilities steadily declined, the decline in each year was undramatic through 1983. As Table 8 also shows, the relatively constant reserve fund and coverage ratios were achieved by substantially reducing the present-value cost of new FSLIC cases after 1982 even though the number of insolvent institutions was growing.

The estimated present-value cost of new assistance cases, which is charged against FSLIC reserves, is the best measure of the burden that FSLIC takes on in a year. (These assistance cases stretch out over five to ten

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Table 8

FAILURES OF FSLIC-INSURED INSTITUTIONS, INSOLVENT INSTITUTIONS, AND FSLIC RESERVES: 1980-1984

	Failures		Estimated GAAP Net Worth				FSLIC Reserves and Costs		
Year	Number of Failures	Assets of Failed Institutions ($ Millions)	Number of Institutions 0<NW/L ≤.03	Assets of Institutions 0 <NW/L ≤.03 ($ Thousands)	Number of Institutions NW/L 0	Assets of Institutions NW/L ≤0 ($ Thousands)	FSLIC Primary & Secondary Reserves ($ Millions)	Ratio of FSLIC Reserves to Insured Liabilities	Estimated Present-Value Cost of New FSLIC-Assisted Case ($ Thousands)
1980	35	2,948	280	35,123,008	17	127,001	6,462	1.34	166,644
1981	81	15,067	653	126,666,366	65	17,303,469	6,302	1.27	987,835
1982	252	46,837	842	204,252,098	201	48,716,430	6,331	1.19	1,127,077
1983	101	15,989	883	242,667,975	287	78,906,404	6,425	1.03	934,739
1984	41	6,800	856	350,360,766	434	107,319,626	5,962	.82	849,842
Total	510	87,581							4,066,137

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years, so the present-value costs are estimates by the FSLIC. Unexpected changes in interest rates and the disposability of assets, therefore, can significantly affect the actual cost.) A sharp increase in these costs occurred in 1981 when the FSLIC committed itself to an estimated $988 million to resolve 31 problem cases. This compares with $167 million to resolve 11 problem cases in 1980. The most costly year in the FSLIC's history was 1982, when the resolution of 77 problem cases was estimated to cost the insurer $1.1 billion in present-value terms. In the two years following 1982, the cost of new FSLIC-assisted cases declined to $935 million in 1983 and $850 million in 1984. As these numbers emerged, the rapidly growing number of insolvent and nearly insolvent institutions may have inferred that the FSLIC's policy was to manage costs in order to maintain the FSLIC reserve fund at a relatively constant level. By 1984, when both the reserve fund and the coverage ratio dropped sharply, it became apparent that the cost of resolving failures was great enough that the FSLIC could no longer maintain the level of fund reserves or coverage level even with fewer failures that year.

As already discussed, moreover, RAP net worth began to deviate from GAAP net worth in 1981. Due to the accounting redefinition, the difference between the number of institutions that were insolvent by RAP accounting and the number that were insolvent by GAAP accounting grew steadily from 24 in 1981 to 363 in 1984. The altered RAP net-worth calculation was another strong indication that the Bank Board and the FSLIC could not close all insolvent institutions.

Between 1981 and 1984, proposals to reform federal deposit insurance by adopting risk-sensitive deposit insurance premiums became more frequent and included endorsements by the Bank Board and the FDIC in reports to Congress

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in 1983.[12] A risk-sensitive premium applied to all FSLIC-insured institutions, however, would raise the premiums paid by insolvent and nearly insolvent institutions. But, as already noted, insolvency itself creates an incentive for these institutions to take greater risk. This incentive has been augmented by the fact that with its current reserves the FSLIC cannot close what may amount to hundreds of insolvent institutions. A risk-sensitive premium that would raise premium costs for these institutions would, therefore, simply create a further incentive to take greater risk in order to recover the additional premium costs.[13] By comparison with a fixed-rate premium, a risk-sensitive premium imposed when the insurer cannot close insolvent institutions may tend to increase risk-taking by insolvent or nearly insolvent institutions because with the fixed-rate premium the institutions do not need to recover additional premium costs.

The inability to close insolvent institutions has important implications for two other often-suggested methods for reducing risky activities of insured-deposit institutions: (1) decreasing the level of deposits covered by deposit insurance, and (2) greater disclosure of the condition of institutions. Decreasing the coverage level, thereby putting additional depositors at greater risk should the insurer close an institution, increases uninsured depositor scrutiny of depository institutions' conduct and performance. With additional uninsured depositor vigilance, uninsured depositors, among other actions, tend to withdraw funds in reaction to diminished performance.

If, however, the insurer is or is perceived to be reluctant to close insolvent institutions, and if little capital and income are at risk, the decreased coverage will tend to increase risk-taking. Although newly uninsured depositors still respond to any deteriorating performance associated with increased risk, the institution--at least for a while--has the

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opportunity to attract new insured and uninsured depositors or hold old ones with higher interest rates. In order to pay higher rates, greater risk needs to be taken. Thus, when the insurer is unable to close insolvent institutions, a decreased coverage level may tend to stimulate risk-taking.

Greater disclosure may tend to speed the reaction of depositors and increase the number of depositors who would react to a decline in condition. Increasing the number of uninsured depositors and providing them with better information when the number of insolvent and nearly insolvent FSLIC-insured institutions is as large as it is today, may increase the probability of widespread runs. Depositors who for the first time would be in jeopardy of losing funds may tend to be highly skittish. Depositors who had been uninsured before the coverage level was reduced and who expected that the insurer would make uninsured depositors whole if an institution failed would reassess their expectation as the number of uninsured depositors grew. As a result, they too might become more prone to withdraw funds.

Risk-sensitive premiums, lower coverage levels, and increased disclosure may also tend to increase risk-taking among solvent institutions. Some insolvent institutions taking greater risk may tend to grow, and in order to grow will offer higher interest rates on liabilities. The most aggressively growing insolvent depository institutions may then determine the level of interest rates paid, and assuming that the supply curve of funds is upward sloping, interest rates on insured deposits may rise to the level necessary to sustain the institution's desired rate of growth. Competing solvent institutions may then react to a shrinking market share of deposits. If the competitors wish to maintain their market share, they will meet the interest rate paid by the insolvent institutions. In order to maintain expected profitability, both the insolvent and solvent institutions will select assets

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with greater expected return and, simultaneously, greater risk. The ceiling on the level of risk taken by the institutions will be set by insolvent institutions and that risk level will be governed by the risk-return preference of the insolvent institution and the insolvent institution's perception of how much risk can be taken before the insurer will close an institution.

V. Conclusions and Unresolved Policy Issues

Although there has recently been an unprecedented number of thrift-institution failures, the even larger number of institutions with negative and extremely low positive levels of net worth indicates that the number of future failures is likely to be large.[14] The FSLIC's reserves, however, are at an extremely low level. The major short-term issue is, therefore, how to handle with limited reserves the large number of insolvent institutions. To the extent that the present value of an institution's assets (tangible and intangible) and liabilities are zero, they should generally be closed. Although the number of such insolvencies may be so large that the FSLIC fund, even with increased industry assessments, is insufficient to handle the problem, not closing these institutions most likely increases the eventual cost to the FSLIC as the institutions try to overcome their problems through riskier activities. Delay itself is therefore costly.

One option suggested by the widespread criticism of RAP accounting is to return to the rules for closure that existed in 1980. If that were done, 434 FSLIC-insured institutions with GAAP net worth to total liabilities less than or equal to zero could be closed. In order to do this, the Bank Board would need to eliminate the changes in Regulatory Accounting Principles that, beginning in 1981, made RAP net worth deviate from GAAP net worth. The Bank

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Board would also need to raise the regulatory minimum net-worth standard from three percent to the five percent that prevailed in the beginning of 1980. This would mean that the number of institutions that would be supervisory cases would rise from about 800 to more than 1600. These changes would mean that institutions representing ten percent of total assets of FSLIC-insured institutions could be closed and institutions representing 68 percent of total assets would be supervisory cases. Based on the least-cost method of resolving FSLIC cases in 1984 this could entail an expenditure of $15.8 billion if all 434 GAAP-insolvent institutions were closed. This potential cost not only underscores the fact that the fund is not designed to cope with an abnormal number of failures, but also that thrift-institution failures have important implications for fiscal and monetary policy and the U.S. deficit.

What regulatory changes are needed in the meantime to limit any "excessive" risk-taking by the troubled institutions, including the possibility of switching from a flat-rate insurance premium to a risk-sensitive one, are also important issues. In the short run, the imposition of a risk-sensitive premium, reducing the coverage level, and increasing disclosure may offer little in terms of reducing overall risk-taking. Moreover, in the face of enormous incentives for nearly insolvent and insolvent institutions to take risks that are excessive from the insurer's view, regulatory changes such as the recent regulation limiting direct investment will be necessary but their overall effectiveness in reducing risk-taking may prove disappointing.

The major long-term issue is whether thrift institutions should be kept separate from commercial banks. Recent technological change, financial innovation, and deregulation suggest that the economic distinctions between the institutions will continue to blur. Competition among thrifts, commercial banks, and other providers of financial services also suggests that the distinctions will be difficult to maintain without significant regulatory action.[15] These forces indicate that the consolidation of function and regulation are issues that will become increasingly important and intense.[16] Simultaneously, the source and amount of home ownership financing will become more of an issue.

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FOOTNOTES

1. An institution is defined to be a failure if liquidated by the FSLIC, merged by the FSLIC with financial assistance, or merged as the result of supervisory action taken by the Federal Home Loan Bank Board.

2. These figures are based upon Generally Accepted Accounting Principles (GAAP). Figures based upon Regulatory Accounting Principles (RAP) are somewhat smaller but nonetheless consistent with the seriousness of the current problem. RAP net worth includes the following items:
   (1) Preferred Stock;
   (2) Permanent, Reserve, or Guaranty Stock;
   (3) Paid-In Surplus;
   (4) Reserves;
   (5) Undivided Profits (Retained Earnings);
   (6) Net Undistributed Income;
   (7) Qualifying Mutual Capital Certificates;
   (8) Income Capital Certificates;
   (9) Net Worth Certificates;
   (10) Qualifying Subordinated Debentures; and
   (11) Appraised Equity Capital.

   These items are reported on the Bank Board's Semiannual Financial Report through 1983 and on the Quarterly Financial Report since 1983. GAAP net worth excluded items (7)-(11) through 1983. Since 1983, Income Capital Certificates have been included in GAAP net worth. GAAP net worth subtracts (adds) deferred net losses (gains) on assets sold. For data on the magnitude of the components that differentiate GAAP from RAP net worth, see Table A-7 in the Appendix.

3. In 1984, the fund declined about seven percent from the 1983 level. Smaller declines occurred in 1950 and 1981.

4. For other recent discussions of many of these same issues, see Kane (forthcoming), Balderston (1985), Merrick and Saunders (1985), Horvitz (1983), Greenbaum (1985), and Carron (1982 and 1983).

5. See Milton Friedman and Anna J. Schwartz, A Monetary History of the United States, 1867-1960, (Princeton: Princeton University Press, 1963).

6. For a study of the implications of deposit insurance and contemporary bank and thrift failures, primarily large-institution failures, see Kaufman (1985). For a more general discussion of the role of the lender of last resort in dealing with financial crises, see Barth and Kelener (1984).

7. For a more detailed description of this phenomenon, especially in the context of the current difficulties faced by thrift institutions, see Brumbaugh and Hemel (1984). Also, see Kareken (1983), Buser, Chen and Kane (1981), Short and O'Driscoll (1983), Clair (1984), Benston (1984), Wall (1984), Keeton (1984), and Flannery and Protopapadakis (1984).

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8. A 1970 Amendment to the Bank Holding Company Act of 1956 defines a bank as an institution that both accepts demand deposits and makes commercial loans. A nonbank performs only one of these services.

9. See the tables in the appendix for more detailed historical data on thrift-institution failures and the FSLIC losses due to the failures. For purposes of comparison, selected commercial bank data are also provided.

10. See Table A-4 in the appendix.

11. For other descriptions of this phenomenon, see Horvitz (December 1983) and Guttentag and Herring (1982).

12. See Federal Home Loan Bank Board (1983) and Federal Deposit Insurance Corporation (1983).

13. Even though a risk-sensitive premium would not reduce overall risk-taking among insolvent and nearly insolvent institutions, it could serve other purposes. For example, if specified activities generated higher premiums, those activities would be discouraged. Thus, if Congress grants the Bank Board's request for authority to charge higher premiums for state-chartered FSLIC-insured institutions engaging in activities not allowed federally chartered institutions, the higher premiums would tend to discourage those activities.

14. For an econometric analysis of the determinants of failure for federally insured thrift institutions, see Barth, Brumbaugh, Sauerhaft, and Wang (1985).

15. For a discussion of increasing competition in the financial services industry, see Rosenblum, Siegal, and Pavel (1983).

16. For an argument in favor of consolidation, see Carron (1984).

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APPENDIX

The tables in this appendix present a historical perspective of thrift-institution failures and the resulting cost to the FSLIC as well as some related data for commercial banks.

Table A-1

FSLIC-INSURED FAILURES: A HISTORICAL PERSPECTIVE*

Year	Number of Failures (1)	Number of Insured Institutions (2)	Number of Insured Accts. of Failed* Institutions (3)	Number of Insured Accts. for all Institutions (thousands) (4)	Assets of Failed Institutions (thousands) (5)	Assets of all Institutions (millions) (6)	Percent of Institutions that Failed (7) = (1)/(2)	Percent of Insured Accts. Held by Failed Institutions (8) = (3)/(4)	Percent of Assets Held by Failed Institutions (9) = (5)/(6)
1934	0	561	0	201	0	150	0	0	0
1935	1	1,117	2	660	13	721	0.09	0	0
1936	0	1,575	0	1,024	0	1,291	0	0	0
1937	0	1,384	0	1,489	0	1,758	0	0	0
1938	4	2,348	1,431	1,833	914	2,127	0.19	0.08	0.04
1939	8	2,199	23,550	2,126	22,143	2,511	0.36	0.96	0.88
1940	7	2,227	9,305	2,592	8,795	2,929	0.31	0.35	0.30
1941	13	2,341	25,180	2,975	28,974	3,353	0.55	0.85	0.86
1942	3	2,298	7,173	3,218	6,414	3,643	0.13	0.22	0.18
1943	1	2,447	199	3,494	635	4,173	0.04	0.01	0.02
1944	1	2,466	292	3,838	268	4,995	0.04	0.01	0.01
1945	0	2,475	0	4,227	0	6,123	0	0	0
1946	0	2,496	0	4,644	0	7,284	0	0	0
1947	1	2,530	831	5,176	1,842	8,528	0.04	0.02	0.02
1948	0	2,616	0	6,122	0	9,715	0	0	0
1949	1	2,756	2,695	7,076	4,884	11,278	0.04	0.04	0.04
1950	0	2,860	0	8,111	0	13,691	0	0	0
1951	0	3,020	0	9,364	0	16,334	0	0	0
1952	0	3,172	0	10,806	0	19,666	0	0	0
1953	0	3,304	0	12,323	0	23,593	0	0	0
1954	3	3,433	1,560	13,773	1,959	28,367	0.09	0.01	0.01
1955	0	3,544	0	15,607	0	34,154	0	0	0
1956	1	3,666	9,106	17,764	22,470	39,138	0.03	0.05	0.06
1957	0	3,772	0	19,788	0	44,449	0	0	0
1958	0	3,981	0	21,832	0	51,311	0	0	0
1959	0	3,979	0	24,374	0	59,550	0	0	0
1960	2	4,098	29,815	27,139	110,361	67,430	0.05	0.11	0.16
1961	1	4,221	3,982	29,815	10,510	77,984	0.02	0.01	0.01
1962	1	4,332	703	32,243	2,780	89,545	0.02	0	0
1963	4	4,419	33,082	34,597	79,564	103,154	0.09	0.10	0.08
1964	4	4,463	28,714	36,507	93,936	114,662	0.09	0.07	0.08
1965	5	4,530	42,409	38,266	180,792	124,576	0.11	0.11	0.15
1966	10	4,510	109,132	40,582	613,790	129,545	0.22	0.47	0.63
1967	6	4,487	26,385	42,225	96,560	138,480	0.13	0.06	0.04
1968	7	4,470	75,884	43,557	385,314	147,736	0.16	0.17	0.21
1969	3	4,408	5,231	46,192	16,982	156,788	0.07	0.01	0.01
1970	10	4,366	267,729	46,537	1,213,029	170,645	0.23	0.58	0.71
1971	7	4,271	48,771	49,225	187,063	199,584	0.16	0.10	0.09
1972	3	4,191	9,905	52,959	26,305	236,349	0.07	0.02	0.01
1973	5	4,163	13,372	57,504	47,763	264,797	0.12	0.02	0.02
1974	2	4,141	41,752	61,797	156,890	288,223	0.05	0.07	0.05
1975	2	4,078	29,831	67,595	119,389	330,254	0.05	0.04	0.04
1976	6	4,044	56,200	73,542	148,097	383,172	0.15	0.08	0.04
1977	3	4,085	54,922	79,316	187,262	449,908	0.07	0.07	0.04
1978	2	4,053	8,773	84,772	23,096	513,310	0.05	0.01	0
1979	3	4,039	120,699	88,182	579,501	568,137	0.07	0.14	0.10
1980	26	4,002	161,702	92,189	2,947,577	618,466	0.65	0.18	0.48
1981	80	3,779	1,860,233	98,740	15,357,357	651,268	2.12	1.88	2.36
1982	252	3,343	2,817,742	88,986	46,836,969	692,563	7.54	3.25	6.76
1983	101	3,060	1,995,031	103,254	15,939,476	859,138	3.32	1.93	1.95
1984**	41	3,167	N/A	108,738	6,799,786	978,514	1.29	N/A	0.69

*"Failure" is defined to be a case requiring supervisory action or FSLIC assistance. Due to lack of data, failure data include only FSLIC-assisted cases prior to 1980, and hence are not directly comparable to subsequent years. Insured accounts data (columns 3 and 8) include only FSLIC-assisted cases for all years.

**Preliminary year-end figures.

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TABLE A-2

COMMERCIAL BANK FAILURE: A HISTORICAL PERSPECTIVE

Year	Number of FDIC-Insured Failures (1)	Number of Banks* (2)	Number of Insured Accts. of Failed Banks** (3)	Assets of Failed Banks (thousands) (4)	Assets of all Banks*** (millions) (5)	Percent of Banks that Failed (6) = (1)/(2)	Percent of Assets Held by Failed Banks (7) = (4)/(5)
1934	9	15,348	15,767	2,561	44,978	0.06	0.01
1935	26	15,480	44,655	17,[illegible]2	48,905	0.17	0.04
1936	69	15,329	89,018	31,941	55,572	0.45	0.06
1937	77	15,094	130,387	40,370	56,907	0.51	0.07
1938	74	14,867	203,961	69,513	56,185	0.50	0.12
1939	60	14,667	392,718	181,514	61,422	0.41	0.30
1940	43	14,534	256,361	161,298	67,304	0.30	0.24
1941	15	14,434	73,305	34,804	75,356	0.10	0.05
1942	20	14,353	90,668	22,254	80,276	0.14	0.03
1943	5	14,197	27,171	14,358	104,222	0.04	0.01
1944	2	14,138	5,487	2,398	125,331	0.01	0
1945	1	14,126	12,483	6,392	146,245	0.01	0
1946	1	14,152	1,383	351	153,507	0.01	0
1947	5	14,182	10,537	6,798	146,374	0.04	0
1948	3	14,189	18,540	10,360	149,799	0.02	0.01
1949	5	14,151	5,671	4,886	149,705	0.04	0
1950	4	14,146	6,366	4,005	156,914	0.03	0
1951	2	14,107	5,276	3,050	165,503	0.01	0
1952	3	14,089	6,752	2,348	177,417	0.02	0
1953	4	14,005	24,469	18,811	181,427	0.03	0.01
1954	2	13,936	1,811	1,138	190,581	0.01	0
1955	5	13,780	17,790	11,985	199,244	0.04	0.01
1956	2	13,640	15,197	12,914	219,000	0.01	0.01
1957	2	13,568	2,338	1,253	224,000	0.01	0
1958	4	13,501	9,587	8,905	240,000	0.03	0
1959	3	13,474	3,073	2,858	245,415	0.02	0
1960	1	13,472	11,171	7,506	258,359	0.01	0
1961	5	13,432	8,301	9,820	279,503	0.04	0
1962	1	13,429	N/A	N/A	298,196	0.01	N/A
1963	2	13,570	36,433	26,179	314,056	0.01	0.01
1964	7	13,761	19,934	25,849	348,433	0.05	0.01
1965	5	13,804	15,817	58,750	378,899	0.04	0.02
1966	7	13,767	95,424	120,647	406,515	0.05	0.03
1967	4	13,722	4,729	11,993	454,603	0.03	0
1968	3	13,579	12,850	25,154	504,637	0.02	0
1969	9	13,661	27,374	43,572	535,680	0.07	0.01
1970	7	13,686	31,433	62,147	577,047	0.05	0.01
1971	6	13,784	71,950	196,520	640,935	0.04	0.03
1972	1	13,928	23,655	22,054	739,592	0.01	0
1973	6	14,172	349,699	1,309,675	835,730	0.04	0.16
1974	4	14,457	704,283	3,822,596	920,001	0.03	0.42
1975	13	14,622	110,367	419,950	966,198	0.09	0.04
1976	16	14,673	340,731	1,039,293	1,030,811	0.11	0.10
1977	6	14,705	95,548	232,612	1,166,146	0.04	0.02
1978	7	14,712	364,384	994,035	1,253,100	0.05	0.08
1979	10	14,708	42,328	132,388	1,352,200	0.07	0.01
1980	10	14,836	78,261	236,164	1,537,200	0.07	0.02
1981	10	14,900	680,308	4,859,060	1,651,300	0.07	0.29
1982	42	14,963	1,964,568	11,632,415	1,820,000	0.28	0.64
1983	48	N/A	934,023	7,206,923	2,027,000	N/A	0.36
1984	79	N/A	N/A	3,276,411	N/A	N/A	N/A

*Commercial Banks

**Includes only the accounts of those failures requiring FDIC disbursement.
Thus 8 banks that appear in column 1 from 1934 through 1980 are excluded from column 3.

***Tentative Numbers

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Table A-3

A COMPARISON OF FAILURE RATES FOR THRIFTS, COMMERCIAL BANKS AND BUSINESSES

Year	Failures (Business) Per 1,000	Failures (Thrift) Per 1,000	Failures (Commercial Banks) Per 1,000
1934	6.10	0	0.60
1935	6.20	0.50	1.70
1936	4.80	0	4.50
1937	4.60	0	5.10
1938	6.10	1.90	5.00
1939	7.00	3.60	4.10
1940	6.30	3.10	3.00
1941	5.30	5.50	1.00
1942	4.50	1.30	1.40
1943	1.60	0.40	0.40
1944	0.70	0.40	0.10
1945	0.40	0	0.10
1946	0.50	0	0.20
1947	1.40	0.40	0.40
1948	2.00	0	0.20
1949	3.40	0.40	0.40
1950	3.40	0	0.30
1951	3.10	0	0.10
1952	2.90	0	0.20
1953	3.30	0	0.30
1954	4.20	0.50	0.10
1955	4.20	0	0.40
1956	4.80	0.30	0.10
1957	5.20	0	0.10
1958	5.60	0	0.30
1959	5.20	0	0.20
1960	5.70	0.50	0.10
1961	6.40	0.20	0.40
1962	6.10	0.20	0.10
1963	5.60	0.30	0.10
1964	5.30	0.90	0.50
1965	5.30	1.10	0.40
1966	5.20	2.20	0.50
1967	4.90	1.30	0.30
1968	3.90	1.60	0.20
1969	3.70	0.70	0.70
1970	4.40	2.30	0.50
1971	4.20	1.60	0.40
1972	3.80	0.70	0.10
1973	3.60	1.30	0.40
1974	3.80	0.50	0.30
1975	4.30	0.70	0.90
1976	3.50	1.50	1.10
1977	2.90	0.70	0.40
1978	2.40	0.50	0.50
1979	2.80	0.70	0.70
1980	4.20	8.70	0.70
1981	6.10	21.40	0.70
1982	8.90	75.40	2.80
1983	N/A	33.20	N/A
1984	N/A	8.80	N/A

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Table 4-4

RISK EXPOSURE TO THE FSLIC

Year	Total Assets Insured Instit. (millions)	FSLIC-Insured Deposits (millions)	Uninsured Deposits in Insured Institutions (millions)	Regulatory Net Worth Insured Institutions (millions)	FSLIC Primary & Secondary Reserves (millions)	Regulatory Net Worth as Percent of Assets	FSLIC Reserves to Insured Savings	Ratio of Insured to Total Deposits	Net Income as a Percent of Assets
	(1)	(2)	(3)	(4)	(5)	(6)=(4)/(1)	(7)=(5)/(2)	(8)=(2)/[(2)+(3)]	(9)
1934	150	n/a	n/a	n/a	1.6	n/a	n/a	n/a	n/a
1935	711	n/a	n/a	n/a	1.9	n/a	n/a	n/a	n/a
1936	1,251	n/a	n/a	78	5.0	6.09	n/a	n/a	n/a
1937	1,750	n/a	n/a	103	10.6	5.86	n/a	n/a	n/a
1938	2,127	n/a	n/a	139	15.8	6.52	n/a	n/a	n/a
1939	2,511	1,716	129	149	20.7	5.77	1.21	93.1	n/a
1940	2,929	2,002	135	182	28.4	6.56	1.27	94.14	n/a
1941	3,353	2,405	154	223	33.3	6.68	1.38	94.17	n/a
1942	3,643	2,556	127	265	38.7	7.27	1.51	95.74	n/a
1943	4,173	3,417	154	307	48.6	7.36	1.11	95.69	n/a
1944	4,995	4,137	182	351	53.3	7.03	1.29	95.79	n/a
1945	6,123	4,941	270	412	62.2	6.73	1.25	94.82	n/a
1946	7,254	5,811	373	488	72.6	6.70	1.25	93.97	1.20
1947	8,528	6,712	465	570	84.5	6.70	1.26	93.52	1.06
1948	9,715	7,716	539	676	97.8	6.96	1.27	93.47	1.02
1949	11,278	9,064	636	804	113.1	7.13	1.25	93.44	1.04
1950	13,091	11,150	716	985	93.6	7.19	0.84	98.10	1.19
1951	16,204	13,323	830	1,189	106.1	7.34	0.80	97.98	1.10
1952	19,686	16,271	961	1,402	120.5	7.13	0.74	97.24	1.01
1953	23,583	19,587	665	1,643	137.7	6.96	0.70	96.72	1.02
1954	28,367	23,746	783	1,926	160.5	6.79	0.67	96.81	1.06
1955	34,750	28,195	1,006	2,321	183.4	6.73	0.65	96.25	1.10
1956	39,138	32,875	1,277	2,699	212.2	6.86	0.65	96.25	1.02
1957	44,480	37,334	1,439	3,139	248.9	6.99	0.66	96.29	0.96
1958	50,311	42,722	1,548	3,596	284.2	7.01	0.67	96.64	0.97
1959	58,562	48,797	2,163	4,182	328.3	6.98	0.67	95.78	0.97
1960	67,430	56,808	2,864	4,718	380.9	7.02	0.68	95.13	0.87
1961	77,384	64,139	5,163	5,463	448.9	7.08	0.69	95.29	0.98
1962	88,545	72,535	4,258	6,305	578.0	7.04	0.93	94.52	0.99
1963	103,254	87,298	5,478	6,987	944.7	6.77	1.15	93.74	0.78
1964	114,652	97,870	4,991	7,885	1,248.9	6.70	1.34	94.90	0.72
1965	124,576	99,352	7,061	8,503	1,537.1	6.62	1.55	93.38	0.67
1966	129,045	106,996	2,817	9,216	1,884.0	6.99	1.80	97.43	0.59
1967	138,480	114,562	3,622	9,489	2,209.1	6.85	1.76	96.96	0.67
1968	147,735	123,184	4,080	10,251	2,489.6	6.94	1.96	96.81	0.62
1969	156,788	128,883	2,112	11,149	2,851.3	7.11	2.17	98.39	0.68
1970	170,646	137,146	4,567	11,910	2,902.8	6.98	2.12	96.78	0.57
1971	189,584	163,480	5,895	13,086	2,986.9	6.55	1.83	96.69	0.71
1972	216,349	190,592	10,028	14,797	3,142.4	6.22	1.65	95.01	0.77
1973	264,797	230,979	10,914	16,529	3,463.5	6.23	1.50	95.05	0.76
1974	288,223	237,336	4,353	17,868	3,791.4	6.20	1.61	98.16	0.54
1975	330,259	271,461	7,223	19,175	4,119.6	5.81	1.52	97.37	0.47
1976	383,172	316,700	11,514	21,372	4,480.1*	5.58	1.41	96.49	0.63
1977	449,798	367,864	15,966	24,525	4,872.9	5.45	1.34	95.78	0.77
1978	513,310	402,541	19,663	28,231	5,338.2	5.51	1.33	96.15	0.82
1979	588,137	430,294	30,400	31,789	5,847.8	5.39	1.36	93.40	0.67
1980	618,466	483,030	20,126	32,436	6,402.1	5.24	1.34	96.38	0.14
1981	661,301	496,108	25,837	27,572	6,181.5	4.17	1.27	95.08	-0.73
1982	682,663	534,123	26,342	25,386	6,330.8	3.86	1.19	95.30	-0.66
1983	819,160	626,267	48,561	32,380	6,455.4	4.13	1.03	92.30	0.27
1984	970,514	723,516	61,259	37,927	5,961.5	3.88	0.82	92.20	2.39

Note: Maximum insurance coverage was as follows for the indicated dates:

1934-49: $ 5,000
1950-65: $10,000
1966-68: $15,000
1969-73: $ 20,000
1974-79: $100,000 for government accounts and
$ 40,000 for all other accounts
1980-84: $100,000

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TABLE 4-5

FSLIC LOSSES

Year	Outlays to date for Insti. Defaulting Specified Year (thousands) (1)	Present Value Projected Future Loss for Defaults, Specified Year (2)	Total Present Value Loss to FSLIC from Insti. Defaults in Given Year** (thousands) (3)=(1)+(2)	Total FSLIC-Insured Deposits (millions) (4)	Loss Per $100 of Insured Deposits** (5)=(2)/(4)	Premium Per $100 Insured Deposits (6)	Excess of Premium Over Insurance Loss Per $100 Insured Deposits** (7)=(6)-(5)
1934	0	0	0	N/A	N/A	.250	N/A
1935	2	0	2	N/A	N/A	.125	N/A
1936	0	0	0	N/A	N/A	.125	N/A
1937	0	0	0	N/A	N/A	.125	N/A
1938	124	0	124	N/A	N/A	.125	N/A
1939	1,791	0	1,791	1,716	.104	.125	.021
1940	942	0	942	2,282	.031	.125	.094
1941	2,303	0	2,303	2,445	.094	.125	.031
1942	238	0	238	2,855	.008	.125	.117
1943	60	0	60	3,417	.002	.125	.123
1944	28	0	28	4,137	.001	.125	.124
1945	0	0	0	4,941	0	.125	0
1946	0	0	0	5,811	0	.125	0
1947	0	0	0	6,712	0	.125	0
1948	0	0	0	7,716	0	.125	0
1949	-43	0	-43	9,064	0	.125	0
1950	0	0	0	11,158	0	.083	0
1951	0	0	0	13,223	0	.083	0
1952	0	0	0	16,271	0	.083	0
1953	0	0	0	19,587	0	.083	0
1954	0	0	0	23,746	0	.083	0
1955	0	0	0	28,135	0	.083	0
1956	-3	0	-3	32,375	0	.083	0
1957	0	0	0	37,154	0	.083	0
1958	0	0	0	42,722	0	.083	0
1959	0	0	0	48,797	0	.083	0
1960	3,477	0	3,477	55,608	.006	.083	.077
1961	189	0	189	64,129	0	.083	0
1962	171	0	171	72,535	0	.083*	0
1963	17,431	0	17,431	82,348	.021	.083*	.062
1964	18,862	0	18,862	92,870	.020	.083*	.063
1965	15,365	0	15,365	99,362	.016	.083*	.067
1966	19,226	0	19,226	106,955	.018	.083*	.065
1967	4,087	0	4,087	116,562	.004	.083*	.079
1968	22,561	0	22,561	123,194	.018	.083*	.065
1969	462	0	462	128,883	0	.083*	0
1970	53,109	N/A	N/A	137,146	.039	.083*	.044
1971	18,944	0	18,944	163,-80	.012	.083*	.071
1972	722	0	722	190,942	0	.083*	0
1973	3,782	0	3,7820	209,979	.018	.083*	.065
1974	6,720	0	6,720	232,126	.004	.083	.079
1975	6,211	0	6,211	271,451	.002	.083	.081
1976	9,599	N/A	N/A	316,700	.003	.083	.080
1977	21,727	N/A	N/A	362,816	.006	.083	.077
1978	4,220	0	4,220	402,541	.001	.083	.082
1979	71,961	N/A	N/A	430,294	.017	.083	.066
1980	1,146,090	N/A	N/A	483,100	.237	.083	+.154
1981	1,447,783	N/A	N/A	498,700	.291	.083	+.208
1982	384,864	N/A	N/A	534,120	.072	.083	+.011
1983	637,910	N/A	N/A	626,397	.102	.083	+.019
1984	681,380	N/A	N/A	723,516	.094	.083	+.011

** Preliminary figure (exclude present value projected future loss, colerm 2)
* 1962-1973 Annual prepayments into the secondary reserve were intermittently required during this period.

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Table A-6

PROFITABILITY OF FSLIC-INSURED THRIFT INSTITUTIONS

Year	Net Income[a] (millions)	Net Operating Income[b] (millions)	Net Nonoperating Income[c] (millions)	Income Taxes (millions)	Regulatory Net Worth (millions)	Net Income as Percent of Previous Year's Regulatory Net Worth
1980	$ 781	$ 790	$ 398	$ 407	$32,436	2.5
1981	-4,631	-7,114	964	-1,519	27,572	-14.3
1982	-4,142	-8,761	3,041	-1,578	25,386	-15.0
1983	1,945	- 46	2,567	576	32,980	7.7
1984	1,165	1,044	911	788	37,927	3.5

[a] Net income is net operating income plus net nonoperating income less income taxes. Due to rounding, the components may not sum exactly to net income.

[b] Net operating income is operating income less operating expenses and interest charges on liabilities.

[c] Net nonoperating income is nonoperating income less nonoperating expenses where nonoperating income comes primarily from profits on the sale of assets and nonoperating expenses comes primarily from losses from the sale of assets.

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TABLE A-7

HISTORICAL COMPARISON FOR ALL FSIC-INSURED INSTITUTIONS OF NET WORTH DEFINED BY REGULATORY ACCOUNTING PRINCIPLES (RAP) AND GENERALLY ACCEPTED ACCOUNTING PRINCIPLES(GAAP)

	Items Included in RAP But Not in Estimated GAAP Net Worth				Items Deducted (Added) When Computing Estimated GAAP But Not RAP Net Worth	Amount by Which RAP Net Worth Exceeds Estimated GAAP Net Worth	
Year	Qualifying Mutual Capital Certificates ($ Thousands)	Income Capital and Net Worth Certificates[a] ($ Thousands)	Qualifying Subordinated Debentures ($ Thousands)	Appraised Equity Capital ($ Thousands)	Deferred Losses (Gains) on Assets Sold ($ Thousands)	Total of All Previous Columns ($ Thousands)	Total Differential as Percent of Total Assets
1980	0	0	0	0	5,784	5,784	0.001
1981	39,500	0	0	0	752,509	792,069	0.122
1982	99,676	472,260	225,624	674,515	3,637,998	5,070,023	0.739
1983	20,252	1,005,628	333,419	1,236,808	4,556,874	7,152,981	0.878
1984[b]	109,791	192,983	1,046,798	1,474,967	6,387,671	9,212,213	0.942

[a] In 1984, accounting procedures were changed such that income capital certificates were included in GAAP net worth, where previously they had been included in net worth only under RAP accounting. Hence, the 1984 figure for this category only reflects net worth certificates.

[b] All 1984 data are preliminary figures.

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northwest national bank a LANE bank

NORTHWEST NATIONAL BANK OF CHICAGO
3985 MILWAUKEE AVE CHICAGO, IL 60641
312/777-7700

August 29, 1985

Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

The Lane Banking Group is composed of four banks in Chicago with aggregate assets in excess of $1.5 billion. We compete in the metropolitan area for commercial lending business and deposits. We are concerned that the federal deposit insurance system as presently administered puts banks our size at a competitive disadvantage vis-a-vis large banks in retaining and attracting deposits over $100,000. Therefore, we are delighted that your Committee has commenced hearings on deposit insurance.

We have prepared the enclosed statement on behalf of the four banks in support of risk-related premiums, universal modified payoff, and more effective supervision. Among the three, only universal modified payoff would cure the unfairness that exists between large banks and smaller banks in gathering deposits. We do not believe, however, that it will ever become a reality. Therefore, something else should be done. We have reviewed all the other suggestions of the regulators and others who have studied the deposits insurance system and none deal with the deposit gathering unfairness issue. For this reason we are suggesting that the insurance level be raised to $1 million. This would allow the smaller bank to retain virtually all of its large depositors because they would have the same protection in the smaller bank as they would have if they moved their deposit to a large bank.

We oppose any general increase in capital ratios because that would exacerbate the unfairness of the system. Small banks do not have the same access to capital markets as large banks.

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Honorable Jake Garn
Chairman

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Mr. Chairman, I respectfully request that our enclosed statement that discusses these issues in more detail be made a part of the record of your hearings on federal deposit insurance.

Sincerely,

William N. Lane, III
Chairman of the Board
Lake View Trust & Savings Bank
Northwest National Bank of Chicago
Northbrook Trust & Savings Bank
Pioneer Bank & Trust Company

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Statement
by
The Lane Banking Group
submitted to
Committee on Banking, Housing and Urban Affairs
U.S. Senate

August 29, 1985

This statement is presented on behalf of the Lane Banking Group located in Chicago, Illinois which consists of Lake View Trust and Savings Bank, Northwest National Bank of Chicago, Northbrook Trust and Savings Bank and Pioneer Bank and Trust Company. These four medium-size banks have total assets in excess of $1.5 billion. The purpose of this statement is two fold. First, it is to discuss the competitive environment in which we and other medium-size banks throughout the country must operate. Second, it is to ask for essential changes in the deposit insurance system that will allow such banks to grow and meet the lending needs of their customers and communities.

The Comptroller General of the United States last fall in his statement to the House Banking Committee on the Continental Illinois rescue observed that the actions of the bank regulators focused attention on the reality that we have two classes of banking institutions that are treated quite differently when problems arise. Some banks have become so large and have established so many relationships with others in the financial services industry that they have become too big to fail. Even though FDIC Chairman William Isaac prefers to

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refer to it as a perception, no bank regulator denies that the largest banks enjoy 100% insurance coverage of deposits.

Other banks do not enjoy such defacto insurance coverage as demonstrated by the liquidation of Penn Square. It is in this environment that the Lane banks compete with money center and other large banks for commercial loan business and large depositors in metropolitan Chicago. The same is true for small to medium-size banks in our other major U.S. cities. There is absolutely no way that such a bank, no matter how good its management, nor how large its capital, can compete on an equal basis with the large bank for deposits over $100,000. A large depositor in a large bank knows that the full faith and credit of the United States stands behind his deposit no matter what its size. In a smaller bank, no matter how careful a large depositor may be in its selection, if unforseen circumstances cause it to fail, he knows the FDIC will decide at that time whether he will be fully protected. Thus, he is subject to loss from the day of deposit for any amount in excess of $100,000.

A smaller bank nevertheless may be able to retain large deposits and maybe even attract some new ones but it will be at a cost. Large depositors are sophisticated and will forgo the safety provided by the FDIC at the largest institutions only if they are compensated for the risk.

The unfairness of the current system due to this disparity of treatment between the largest banks and others

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should be addressed by Congress. We congratulate the Committee for holding these hearings on deposit insurance and are confident that the outcome will be fair and even-handed legislation.

Having said this we must admit the solutions are not easy. Legislation cannot be developed on a clean slate because over fifty years of experience under current law has brought us to the situation we have described. New legislation must move us from where we are to a deposit insurance system that will fairly and effectively provide depositor confidence and financial stability in the years ahead.

A number of proposals have been suggested as a result of the efforts of the deposit insurance agencies, the Vice-President's Task Group, the President's Cabinet Council and others. We would like to comment on some of them and then make a suggestion of our own.

The FDIC and the FSLIC have submitted comprehensive packages for reform but most of the attention has centered around the proposals to enhance bank risk sensitivity through market discipline or regulation.

Risk related insurance premiums have been suggested by the FDIC and others as a way to reduce the unfairness in the cost of the insurance system between well managed banks and those with riskier assets. In addition, higher premiums would penalize the more risky bank and deter excessive risk-taking. We agree with the concept and support it. However the proposed

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risk related premium systems would not ameliorate the unfairness in the insurance system as between the largest banks and other banks in gathering deposits.

The FDIC has developed and tested a modified payoff approach to bank failures as a means to instill depositor discipline over banks. Under this approach all depositors over $100,000 are subject to some loss. Chairman Isaac told the Committee, however, that the FDIC has concluded that this approach has too many disadvantages compared to its advantages. This is unfortunate because the modified payoff applied universally to all banks would restore fairness between different size banks. We support his approach and note that Acting Comptroller of the Currency Joe Selby supported an approach of this sort in his testimony before the Committee.

Another market discipline approach looks to the investor rather than the depositor for discipline and the FDIC has settled on it as the appropriate approach. The FDIC proposes that the uniform minimum capital ratio for banks be raised from 6% to 9%, allowing up to 3% to be satisfied by subordinated debt. While it does not say so, one must surmise the FDIC would prefer the additional capital be subordinated debt. It's major argument in support of increased capital is that subordinated creditors, who, unlike shareholders, do not share in the rewards of successful risk-taking, would be very discerning in providing and pricing capital.

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While a higher capital ratio satisfies the FDIC's wishes for greater market discipline to lessen risk, the Acting Comptroller testified that such increase is likely to be ineffective in strengthening the banking system and may even weaken it. Regardless of who is correct regarding this issue, one thing is for sure, a higher capital ratio does not address the unfairness in the deposit gathering marketplace caused by some banks being too big to fail.

The higher capital proposed not only would fail to ameliorate the current unfairness but it would increase the unfairness of the system. Small to mid-size banks do not have the same access to the capital markets as big banks. They would have a much more difficult and costly time selling subordinated debt or other capital. Chairman Isaac attempts to meet this argument by pointing out that as a group the 12,000 banks under $100 million in size currently have average primary capital equal to 9.1 percent. This statistic in no way helps the individual small bank with under 9% capital or the medium-size bank over $100,000 million that has limited access to the capital markets. Also Chairman Isaac's references to retained earnings, controlled growth and private placement of subordinated debt with correspondent banks, insurance companies and pension funds are easier said than done. We believe the current capital ratio is adequate particularly considering the authority of the regulators in individual cases to increase it. We oppose any general increase of capital.

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Chairman Isaac told this Committee if the increased capital ratio proposal were implemented, "the FDIC would discontinue its efforts to achieve greater depositor discipline. We would recommend leaving the dejure insurance limit at $100,000, but we would in fact provide 100% coverage by endeavoring to arrange mergers for failed banks of all sizes".

If a 100% defacto insurance system would be in the public interest it is difficult to understand why a 100% dejure insurance system would not be. This brings us to our suggestion. None of the above proposals except the modified payoff which has been rejected by the FDIC would eliminate the big bank unfairness in the current system. Therefore we suggest that the unfairness be ameliorated by increasing deposit insurance coverage not to 100% but to a fixed amount of $1 million. This increase would give many large depositors in smaller banks protection equivalent to the deposit protection they would receive in a money center bank. Also, a one million dollar FDIC protection would give market discipline a chance to work, if it is going to, for the small to mid-size bank with respect to attracting deposits over the amount.

The impact of such a change would not have as great an impact on the FDIC fund as might first be thought. The vast bulk of deposits over $100,000 are in big banks already 100% insured. As time passes with the current unfairness in the system more large deposits will move to the big banks from the

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smaller ones. Deposit brokers have already pretty much destroyed any distinction between $100,000 and $1 million in the case of a bad bank.

A poorly run bank that has abused interest rate deregulation, prudent lending standards and the current $100,000 insurance level through brokered deposits will find little difference in obtaining one $1 million deposit, or ten $100,000 deposits. The answer to the badly managed bank problem is a more highly qualified and expanded regulatory staff that will allow regulators to identify and deal with mismanagement and abuse. This we support. Also the risk-based premium, which we support, is a further answer to the riskier bank.

In conclusion we believe the deposit insurance system should be fair to all banks. It is wrong for the system to give the largest banks a competitive advantage in deposit gathering. None of the proposals address the current problem except for universal modified payoff which is very unlikely to be enacted or implemented. Therefore, we urge the Congress to raise the insurance coverage to $1 million. This will allow the smaller bank to retain and compete for new large deposits without going to a fully insured system which the FDIC Chairman has indicated a willingness to see in fact.

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EPIC Group's Collapse Triggers Higher Rates

By Michael Abramowitz
Washington Post Staff Writer

The forecasted ripple effects from the collapse of Equity Programs Investment Corp. (EPIC) have begun to materialize, as investors reassess private mortgage-backed securities that financed the real estate investment group's purchase of new homes.

The most tangible manifestation of this nervousness is that thrifts and mortgage bankers have been forced to pay higher interest rates to attract investors in private mortgage-backed securities, Wall Street analysts say. These higher rates ultimately will be passed on to the small portion of home buyers who obtain mortgages financed through these types of securities, mortgage finance officials said.

"Whenever there's a default or potential loss of the size of EPIC, the market tends to overreact," said Stephen Pasko, managing director in charge of mortgage finance at Drexel Burnham Lambert. "The primary reason is that the investors, because of the EPIC situation, are concerned about the risk with private mortgage insurance."

"There is concern in the mortgage-backed security market about the quality of certain mortgage-backed securities. There is certainly no panic, but there is caution," added Richard Dorfman, a managing director at Shearson Lehman Brothers.

Evidence of concern over the private issues can be seen in the widening spreads brokerage houses are reporting between the yields on Treasury securities and those demanded by investors in private-mortgage backed securities.

Typically, yields on Government National Mortgage Association (Ginnie Mae) issues are about 1¼ percentage points higher than yields on Treasury securities, said Gary Lieberman, national sales manager for mortgage securities at Merrill Lynch. Ten-year Treasury securities were trading at about 10.4 percent this week.

Lieberman said the private issues usually return about another quarter of a percentage point above the Ginnie Maes. In the wake of the EPIC debacle, however, this spread has widened by about another quarter of a percentage point. Wall Street sources said, evidence of skittishness about the reliability of these types of issues.

Although the private secondary mortgage market is still far smaller than the public market, it has grown in recent years as a source of funds for mortgage-seekers who cannot obtain mortgages backed by government agencies. Wall Street officials who have pushed the growth of this market said they are worried the shakeout from EPIC in the mortgage insurance industry could impinge on this growth.

Those insurance companies are currently facing losses that could reach $400 million as a result of the default of EPIC partnerships on $1.4 billion worth of mortgages and mortgage-backed securities. The companies are trying to restructure the EPIC mortgages to avert the worst-case losses, which would be the industry's biggest ever.

Yesterday, however, a group of eight major investors in EPIC mortgages and mortgage-backed securities announced that it had rejected a plan developed by the insurer with the most to lose at EPIC, Ticor Mortgage Insurance Co. The plan calls for a reduction of the monthly interest payments owed by the partnerships, as well as a cash contribution by the insurance companies to meet those payments.

A statement issued by the Federal National Mortgage Association, one of the investors, said that after a meeting yesterday the investors agreed the Ticor plan "does not constitute the basis for an equitable solution to the problem," and that they instructed their lawyers to draw up another plan.

The ultimate resolution of the EPIC situation will have a major impact on the mortgage insurance industry, which plays a crucial role in the market for private mortgage-backed securities. A mortgage-backed security is created when a lender pools a group of mortgages and sells them to investors, to whom monthly mortgage payments are then passed on.

The vast majority of the market, in the neighborhood of $350 billion, is composed of mortgage securities guaranteed by the quasi-governmental agencies: the Government National Mortgage Association, the Federal Home Loan Mortgage Corp. and the Federal National Mortgage Association.

A smaller, but growing, market has emerged through the private sale of mortgage-backed securities. Totaling between an estimated $15 billion and $30 billion, this market is dependent on private mortgage insurance, because that is the only protection afforded investors beyond the actual value of the properties underlying the mortgages.

Although the public market has come through the EPIC disaster unscathed, mortgage finance officials say, a feeling of unease has drifted through the private market as a result of the potential damage EPIC holds out for the mortgage insurance companies with exposure from the partnerships.

WEDNESDAY, SEPTEMBER 18, 1985

TEXAS SAVINGS & LOAN LEAGUE • 408 W. 14TH ST. • AUSTIN, TEXAS 78701 • 512/476-6131

July 23, 1985

Mr. Danny Wall, Staff Director
Senate Committee on Banking, Housing
and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Wall:

Enclosed please find the Texas Savings and Loan League's offical position paper. This may be of benefit to you and Senator Garn as you open hearings on many of the subjects contained therein.

If we can be of any service to you, please do not hesitate to call.

Very truly yours,

Tom S. King,
Executive Vice President

TSK/lmm

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The Texas Savings and Loan League recognizes the necessity to solve the basic current concerns of both the savings and loan business and its regulators. The following proposal, approved and endorsed by the Texas Savings and Loan League, addresses those concerns with a comprehensive legislative and regulatory program:

I. Recapitalization of the Federal Savings and Loan Insurance Corp.

A. Require each association to purchase additional stock in the Federal Home Loan Bank in an amount equal to one percent of net assets at one-quarter of one percent per year for four years. This would add an additional $10 billion in Capital to the bank.

B. Require the Federal Home Loan Bank to purchase subordinated debt of the FSLIC over the four-year period, which would infuse $10 billion into the fund. This debt will be collaterlized by the FSLIC with currently held and future-accquired Real Estate Owned (REO).

C. Authorize the transfer by trust receipts of REO currently held and future acquired by the FSLIC to the district Federal Home Loan Banks for liquidation. The district banks would then assign the REO by trust receipt to S&Ls in the areas in which the REO is located and utilize the expertise of those S&Ls to maximize the return from its liquidation.

D. Cancel the FSLIC's one-eighth of one percent per year special assessment and forgive amounts already paid in.

II. Recapitalization of Individual Savings and Loan Associations.

A. Withdraw the present net worth and growth regulations and in their place adopt a regulation requiring all S&Ls to achieve and maintain levels of net worth to total liabilities calculated pursuant to the following schedule:

1. Dec. 31, 1984 3.00% net worth to total liabilities.
2. Dec. 31, 1985 3.25% net worth to total liabilities.
3. Dec. 31, 1986 3.50% net worth to total liabilities.
4. Dec. 31, 1987 3.75% net worth to total liabilities.
5. Dec. 31, 1988 4.00% net worth to total liabilities.
6. Dec. 31, 1989 4.25% net worth to total liabilities.
7. Dec. 31, 1990 4.50% net worth to total liabilities.
8. Dec. 31, 1991 4.75% net worth to total liabilities.
9. Dec. 31, 1992 5.00% net worth to total liabilities.

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B. Associations which did not attain a three percent net worth on December 31, 1984, as required by the above schedule, will be required to make up the deficiency in a series of eight equal annaul installments beginning December 31, 1985. In addition to recapturing the deficiency, associations must adhere to the schedule of net worth accumulation outlined above.

C. Once an association has attained a five percent net worth, it must maintain that level, as reflected in semi-annual reports.

III. Reassessment of FSLIC Future Risks

Revoke the direct investment regulation and in its place:

A. If a thriftness test is needed, the League recommends the use of the 60/40 percent asset composition test contained in Section 7701(a)(19) of the Internal Revenue Code of 1954, as amended, defining a Domestic Building and Loan association, with the addition of a provision recognizing our mortgage banking activities.

B. Establish a risk-based insurance premium for FSLIC insurance for perceived extra risks as a result of direct investments made by an association. The extra risk premium would be assessed on those direct investments over 10 percent of assets. This extra-risk premium would be reduced by one third for each one percent additional net worth over five percent maintained by an association. Any association with eight percent or more net worth would not be subject to the increased risk-based premium for FSLIC insurance.

-or-

C. Authorize an association to join an approved state supplemental fund which would provide the FSLIC with up-front protection. In this case, an association would not be subject to the increased risk-based premium for FSLIC insurance.

-or-

D. Utilize a workable combination of both risk-based premium for FSLIC insurance and participation in an approved state supplemental fund.

IV. Reassesment of State Supervision

A. The Federal Home Loan Bank Board should publish a written standard of supervision that both federal and state supervisors must maintain.

B. An independent commission should be established to test the equality and effectiveness of examination and supervision at both the state and federal level against the published written standard.

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BANKERS' ASSOCIATION FOR FOREIGN TRADE

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EXECUTIVE DIRECTOR
MARY CONDERLIS
WASHINGTON, D.C.

October 10, 1985

The Honorable Jake Garn
Chairman
Committee on Banking, Housing
& Urban Affairs
United States Senate
Dirksen Senate Office Bldg.
Room SD-534
Washington, D.C. 20510

Re: Hearings on Deposit Insurance Reform

Dear Chairman Garn:

The Bankers' Association for Foreign Trade ("BAFT") is a trade association of money-center, regional and smaller banks dedicated to promoting international trade and finance. Its 135 voting members comprise virtually all U.S. banks actively involved in international banking and trade finance.

In connection with the Banking Committee's recent and continuing hearings on possible reforms to the deposit insurance system, we note that, at several points, the issue has been raised of whether foreign branch deposits of U.S. banks should be subject to FDIC premium assessments. Unfortunately, to date, the few witnesses who have raised the issue have done so either in a conclusive or cursory manner. As was recently suggested by Chairman Volcker of the Federal Reserve in his written statement of September 11, 1985 before the Committee, this issue is a complex and difficult one and a full and careful assessment must be made of the pros and cons involved. In this regard, BAFT has prepared a statement on this issue which is enclosed and which addresses the major public policy detriments which we believe would result from FDIC assessments on foreign branch deposits. We respectfully request that this statement be included in the record of the hearings.

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In BAFT's view, extending FDIC premiums to cover foreign branch deposits of U.S. banks is unnecessary from a fairness standpoint and counterproductive from a risk standpoint. The only certain result is that the added costs of assessments would make it more difficult for U.S. banks to compete abroad and to finance the international needs of their U.S. customers on a competitive basis. This result is certainly not in the public interest when the U.S. is facing record merchandise trade and balance of payments deficits and when substantial efforts are being made by the Administration and you to reduce barriers to U.S. banks abroad.

Sincerely,

David H. Dorminey
President

DHD/jyh
cc: The Honorable William Proxmire
Ranking Minority Member

All Members of the Senate Committee
on Banking Housing and Urban Affairs

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STATEMENT OF THE

BANKERS' ASSOCIATION FOR FOREIGN TRADE

IN OPPOSITION TO PROPOSALS TO IMPOSE

FDIC ASSESSMENTS ON FOREIGN BRANCH

DEPOSITS OF U.S. BANKS

SUBMITTED TO:

Committee on Banking, Housing and Urban Affairs
United States Senate

October 10, 1985

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INTRODUCTION

For fifty (50) years, it has been the public policy of the United States to exclude deposits at foreign branches of U.S. banks from Federal Deposit Insurance Corporation ("FDIC") assessments and coverage. This policy was established in 1935 and reaffirmed by Congress in 1981 when it also exempted deposits at International Banking Facilities ("IBFs") from FDIC assessments and coverage, because the additional costs associated with FDIC assessments would put U.S. banks at a serious disadvantage in competing internationally.

Recently, however, proposals have been made to impose FDIC assessments on foreign branch deposits of U.S. banks as a way of increasing the size of the FDIC fund and of making large money-center banks pay more premiums into the fund. The Bankers' Association for Foreign Trade ("BAFT"), a trade association of 135 U.S. banks actively involved in international banking and trade finance, is strongly opposed to such proposals because they would clearly be detrimental to the foreign trade, economic, and foreign policy interests of the United States and would likely increase systemic risks to the U.S. and international banking systems.

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ASSESSMENT OF FOREIGN BRANCH DEPOSITS IS UNNECESSARY

Proposals to include foreign branch deposits in the FDIC assessment base have generally been based on either of two premises.

First, it has been suggested that assessing foreign branch deposits of U.S. banks would be one way of increasing the size of the FDIC fund. However, officials of the FDIC have consistently stated that the size of the FDIC fund is adequate. As of July 31, 1985, the FDIC had assets of $23.8 billion and an insurance fund of over $18.8 billion. Simply put, there has been no showing to date that the FDIC needs additional funds, whether derived from assessment of foreign branch deposits or other sources.

Second, it has been suggested that assessment of foreign branch deposits is "fair" because such deposits are de facto insured by the FDIC. Because section 3(1) of the FDIC Act expressly excludes foreign branch deposits from FDIC insurance, such suggestion has apparently been based on the premise that any bank having foreign branches is "too big to fail" and its foreign depositors would thus be made whole by the FDIC. We believe that premise is wrong on several counts.

Firstly, the premise that some banks are "too big to fail" is merely a hypothesis: it is neither proven fact nor established public policy. As the Committee's hearings

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have already demonstrated, opinions differ sharply over the validity of this premise. In this connection, the Committee has already received a number of thoughtful suggestions from bank trade associations and other witnesses for approaches to dealing with bank failures which would ensure that no bank is too big to fail, i.e., that all banks regardless of size would be treated equally in a failure situation. We note further that, at his recent confirmation hearing, Mr. Seidman stated that (if confirmed as Chairman of the FDIC) he would like to come up with a plan "that makes it clear that all banks, no matter what the size, can be treated in the same way under similar circumstances."[1/] Even Chairman Isaac, who has supported including foreign branch deposits in the FDIC assessment base, admitted in testimony before the Committee that if foreign branch deposits could be excluded from (de facto) coverage then there would be no reason to assess them.[2/]

Secondly, the "too big to fail" premise begs the obvious question of which banks are "too big to fail." Who draws this line and where is it drawn? Federal Reserve figures indicate that 166 U.S. banks have foreign branch operations. If foreign branch deposits were assessed, would that mean that

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1/ Transcript of September 19, 1985 at 24.

2/ Transcript of July 23, 1985 at 23.

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all such 166 banks would be "too big to fail"? If not, would it be fair to require banks to pay assessments on their foreign branch deposits when, in fact, their foreign branch depositors would not be covered by the FDIC?

Lastly, the "too big to fail" concept turns the basic purpose of the FDIC on its head. Under such concept, instead of being an insuror of U.S. retail deposits, the FDIC would become an implied guarantor of the worldwide operations of U.S. banks. We respectfully submit that such a radical change in the FDIC's mission has implications far beyond the assessment of foreign branch deposits.

ASSESSMENT OF FOREIGN BRANCH DEPOSITS IS DETRIMENTAL TO BROADER PUBLIC POLICY INTERESTS OF THE U.S.

Each time Congress has looked at the issue of whether foreign branch deposits should be assessed and insured -- in 1935 and again in 1981 in connection with IBFs -- it has concluded that assessment of such deposits would seriously harm the ability of U.S. banks to compete in international markets, and that such harm outweighed any marginal increases to the FDIC fund.

Given this longstanding public policy, those who may propose assessing foreign branch deposits must bear the burden of demonstrating that this change would not seriously damage the competitive position of U.S. banks abroad. From

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our standpoint as a trade association of international bankers, the competitive reasons which led to the exemption of foreign branch deposits from FDIC assessments are even more compelling today than they were 50 years ago when the original exemption was enacted.

First, international trade is much more important to the U.S. economy today than it was fifty years ago. International markets are also much more competitive today than they were fifty years ago, as U.S. businesses and banks find themselves competing with an ever-growing list of highly sophisticated and sometimes government-owned or supported foreign businesses and banks.

Second, services are now the most important segment of the U.S. economy, and are the key to the future competitiveness of the U.S. in international markets. The Trade in Services Study, which was submitted by the United States to the General Agreement on Tariffs and Trade ("GATT") in December 1983, stated that services, including government, now account for two-thirds of U.S. gross national product and 70 percent of U.S. employment. The United States is the largest exporter of services ($34.9 billion in 1980), and it is believed the amount of U.S. service sector exports are much greater than those reported. In this connection, in a study done for the

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Departments of State and Commerce and Office of U.S. Trade Representative, an independent consultant estimated that foreign revenues from the international business operations of the U.S. banking industry in 1980 were $9.1 billion (on a net basis), making banking the second largest U.S. service sector internationally in terms of revenue.

Third, U.S. banks' share of world banking assets has decreased markedly over the past decades, as competition from large foreign banks has intensified. After the end of World War II, U.S. banks held approximately 50% of the assets of the world's 100 largest banks. By the end of 1983, the percentage had declined to 14%.

Lastly, given a mechandise trade deficit approaching $150 billion and a growing balance of payments deficit, now is not the time to take actions which would make it more difficult for U.S. banks and their customers to compete abroad.

REDUCED U.S. INTERNATIONAL COMPETITIVENESS

U.S. banks play a double role in American trade competitiveness. There is a direct role, in that service exports are extremely significant to the overall U.S. balance of payments and help to compensate for the widening U.S. merchandise trade deficit. As previously noted, banking is the second largest U.S. service sector internationally in terms of revenue. In addition, U.S. banks finance U.S. exporters.

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Should U.S. banks' ability to function in international markets be damaged, so will their ability to service American exports.

There is no doubt that FDIC assessments would put U.S. banks at a serious competitive disadvantage in international markets. Intense competition in foreign markets has created spreads which are relatively thin, especially in such important operations as interbank placements. FDIC assessments would result in a tax of 6-8 basis points on all international deposit transactions.1/ U.S. banks would not be able to pass this tax on to their customers because, since their major competitors are foreign banks which do not bear this cost, passing it through would make U.S. banks' prices noncompetitive. This added tax would simply be another disadvantage imposed on U.S. banks in their efforts to compete with foreign banks that frequently operate under foreign government ownership or support with lower capital ratios, lower effective reserve requirements, and generally fewer operating constraints. In this connection, U.S. banks have been losing market share and are now second

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1/ The current FDIC assessment rate is 1/12 of 1% or 8.3 basis points. Senator Proxmire proposed last year an assessment rate of 1/15 of 1% or 6.7 basis points on all deposits, including foreign branch deposits. While rebates could theoretically reduce these rates, international banking transactions cannot be priced on the basis of future rebates which may or may not occur. In this regard, since 1980, FDIC rebates have varied substantially due to increased bank failures.

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to Japanese banks in the international market. See Exhibit A. Given the thinness of margins in the Euromarkets -- frequently as low as 25-40 basis points -- it is clear that even a 6-8 basis points added cost could make a critical difference in many transactions.

The ultimate problem is not simply a loss of business or reduced profits for U.S. banks, developments which, in and of themselves, would hurt the U.S. balance of payments. If U.S. banks are burdened by a special FDIC tax which does not apply to foreign banks, then it becomes more difficult for them to extend competitive international financing to their U.S. customers who must compete for foreign sales against non-U.S. companies financed by non-U.S. banks. The result will be reduced U.S. exports at a time when we are facing a record merchandise trade deficit.

REDUCED LIQUIDITY IN THE EURODOLLAR MARKET

Access to the Eurodollar market is an important component in U.S. bank liquidity. This market is primarily a wholesale market, and for banks which are active in international lending, it acts as a source of deposits as well as an important tool in the management of interest maturity exposure. Purchases of deposits and of foreign exchange in the Eurodollar market allow banks to hedge and protect themselves from volatility in interest rate and foreign exchange risks. The inter-

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bank market endows U.S. banks with maximum flexibility and liquidity -- both of which heighten bank safety by increasing the ability to meet unforeseen needs.

The liquidity of this market has already been attenuated by the impact of international credit problems and increased U.S. bank capital ratios, which have resulted in a reduced level of interbank placing. In 1981, U.S. banks' claims on foreign banks, i.e. liquid Eurodollar deposits, totalled $150 billion: by year-end 1984, this source of liquidity had shrunk by one-third to $100 billion. See Exhibit B. FDIC assessments on foreign branch deposits would exacerbate this diminution in liquidity, as premiums would be assessed on each international deposit transaction -- resulting in fewer transactions and a further decline in overall liquidity (gross turnover in the Eurodollar market today exceeds the net loans and deposits, since a deposit made with one bank may be on-lent through several banks before reaching the ultimate borrower). Less liquidity clearly means less capacity on the part of U.S. banks to manage risk and to support U.S. industry's international financial needs.

SPECIAL DISINCENTIVES TO REGIONAL BANKS

Contrary to conventional wisdom, the impact of FDIC assessments on foreign branch deposits may, in the long run, be more damaging to the international operations of regional

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banks than money-center banks. While money-center banks would face significant increases in FDIC assessments if foreign branch deposits were covered, such banks may be able to reduce the impact of such assessments through the increased use of foreign subsidiaries and non-deposit funding strategies. Regional banks lack the extensive networks and resources to reduce the impact of FDIC assessments and are thus likely to experience a more direct bottom-line impact on their international earnings. As a result of the thinness of international spreads and higher capital requirements, many regional banks are already cutting back their international activities by closing foreign offices and reducing interbank placements and lending activities. The additional costs associated with FDIC assessments may cause a further retrenchment of regional banks' international activities at a time when they are being encouraged to maintain their crucial role in financing the exports of middle-market and smaller U.S. customers and in lending to the LDCs. A reduced role for regional banks means less U.S. exports, less needed new money for the LDCs, and a further concentration of international lending at the major money-center banks, developments which would be harmful to interests of the U.S. and the world's trading and financial system.

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INCREASED RISKS TO THE FDIC FUND AND FOREIGN POLICY COMPLICATIONS

If foreign branch deposits of U.S. banks were to become subject to FDIC assessments, then such deposits would presumably be covered by FDIC insurance, greatly increasing the exposure of the FDIC fund. Even if such deposits were not de jure covered, the fact that they were being assessed would create the strong implication of de facto coverage by the FDIC. Such de jure or de facto coverage could result in significant legal problems for the FDIC and in potential foreign policy problems for the U.S. For example, in 1984, the Philippine Treasury exhausted its supply of foreign currency and the government prohibited local banks -- including local branches of U.S. banks -- from repaying dollar deposits upon maturity. With foreign deposits assessed and de jure or de facto insured by the FDIC, such situations would be open invitations to depositors to sue the local U.S. bank branches and their insurer, the FDIC, to obtain their funds. Similar calls on the FDIC could arise in conjunction with other events (which have occurred) such as foreign government expropriation of U.S. bank branches. These and many other novel legal and supervisory problems could increase risks to the FDIC fund and, in many cases, could cause unwarranted regulatory or foreign policy problems with host country governments.

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FOREIGN DEPOSIT ASSESSMENTS ARE INCONSISTENT WITH GREATER RELIANCE ON MARKET DISCIPLINE

Imposition of FDIC assessments on foreign branch deposits would be convincing evidence of a moral and supervisory commitment by the FDIC to stand behind the worldwide operations of U.S. banks. Such a commitment reduces the market discipline which exists today in international funding markets, a discipline which the FDIC wishes to enhance and which is the most effective check on undue risk in banking operations. By weakening market discipline and establishing **de jure** or **de facto** coverage of worldwide operations, FDIC assessments on foreign branch deposits would thus increase, rather than decrease, the systemic risks now faced by the FDIC.

CONCLUSION

Proposals to include foreign branch deposits in the FDIC assessment base are based on a "too big to fail" hypothesis which is unproven, which is unfair to regional and smaller banks, especially with foreign branch operations, and which would entail a radical change in the FDIC's mission. Continued exemption of foreign branch deposits from FDIC assessments is based on a longstanding and sound policy of maintaining the competitiveness of U.S. banks in international markets. A change in this policy to assess foreign branch deposits would result in reduced competitiveness of U.S. banks in foreign markets,

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reduced U.S. exports, reduced lending to small businesses involved in international activities, reduced lending to the LDCs, reduced competition in international lending among U.S. banks, reduced liquidity in international markets, and reduced market discipline in international banking. While such assessments might provide a small increase in FDIC income, that increase would be dwarfed by increased risks to the FDIC fund, increased systemic risks to the international banking system and increased legal and supervisory problems.

In sum, BAFT believes extension of FDIC assessments to the foreign branch deposits of U.S. banks would be contrary to the public policy interests of the United States.

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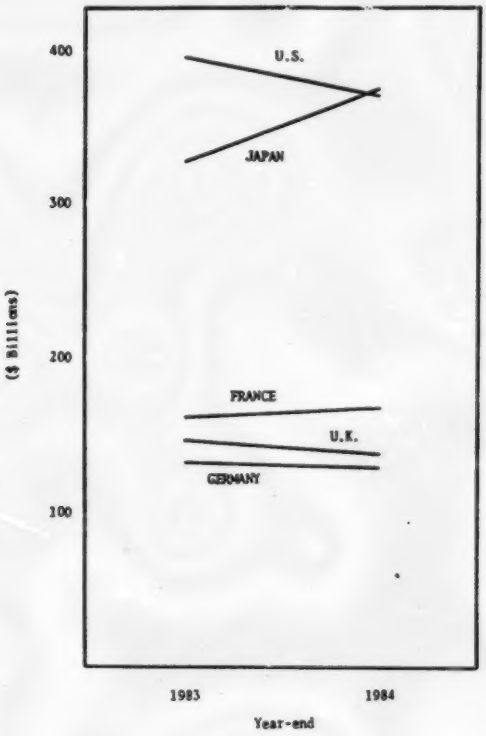
EXHIBIT A

INTERNATIONAL ASSETS OF BANKS BY COUNTRY OF PARENT BANK



DATA:
(in billions)

	Assets	Market Share	Assets	Market Share
	1983		1984	
U.S.	$393.7	26.4%	$369.5	24.4%
Japan	$326.2	21.9%	$372.1	24.6%
France	$160.8	10.8%	$167.7	11.1%
U.K.	$146.9	9.9%	$137.1	9.1%
Germany	$132.0	8.9%	$129.6	8.6%
All Other	$331.5	22.1%	$335.8	22.2%
TOTAL	$1491.1	100%	$1511.8	100%

SOURCE: BIS, May 10, 1985, "The Nationality Structure of the International Banking Market and the Role of Interbank Operations".

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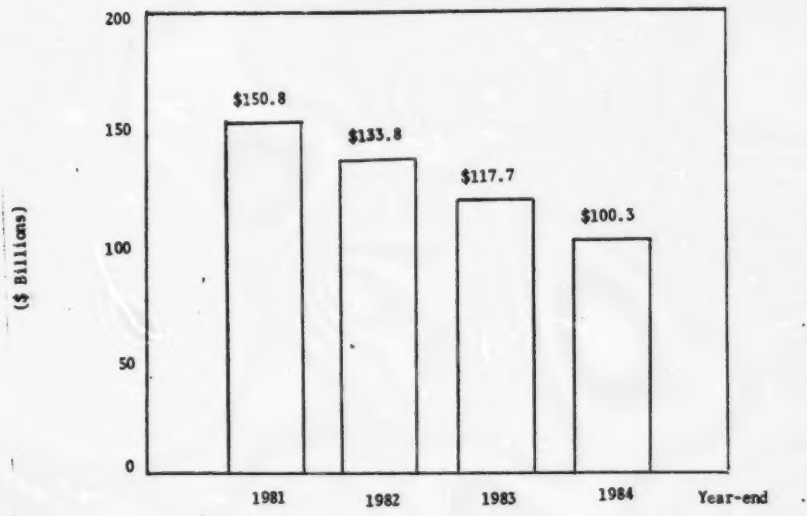
EXHIBIT B

INTERBANK PLACINGS OF U.S. BANKS TO FOREIGN BANKS



DATA:
(in billions)

Year	Placings
1981	$150.8
1982	$133.8
1983	$117.7
1984	$100.3

SOURCE: Federal Reserve Bulletin - TABLE 3.14

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Submitted
By

GERALD F. FITZGERALD

CHAIRMAN, SUBURBAN BANCORP, INC.

NOVEMBER 1985

STATEMENT FOR THE UNITED STATES SENATE
RELATING TO FEDERAL DEPOSIT INSURANCE

Fifty-one years ago, the original intent of the legislation enabling the FDIC and FSLIC was to protect the small depositor from the immediate problems associated with bank failures. Up to now, this program has worked admirably protecting several hundred million depositors.

The amount insured has increased from $2,500 to $100,000 per account, and in effect now insures formally all the deposits of probably 98% of depositors and protects informally 99% of the depositors of small banks, and 100% of the depositors of large banks.

Problem of Mismanagement

Because it is now stated public policy that no large bank will be allowed to fail, market forces are prevented from disciplining mismanaged large banks. The $100,000 amount of deposit insurance per account has caused most depositors to have zero concern with the safety or soundness of their depository institution, refocusing their sights on where and how they can get maximum yield without the normal concern of risk.

In short, the blessing of deposit insurance has now become a curse of irresponsibility both for many institutions and most depositors.

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Protecting the "System" and the Small Depositor

The concerns in the early 1930's centered around protecting the small depositor. Today the concern is protecting the small depositor as well as protecting the "system." The thought of a large bank failure and its consequences is unfathomable because of the unimaginable disruption it would cause with correspondent banks and countless corporations depending on payroll services and short-term operating funds.

We propose, therefore, that the Senate consider assigning two aims to future deposit insurance:

1. Protecting the "system"
2. Protecting the small depositor.

Money Movement

Hundreds of billions of dollars are swishing through the commercial banking system daily. Indeed, demand deposits are turning over more than twice daily in money center banks. This must be compared to our national average of a twice-monthly turnover before World War II. The time value of money over the past 40 years has become so great that bank users have found systems that allow them to move money more than 30 times faster than 50 years ago, and the pace is accelerating.

With new electronic techniques, it is possible for the same dollar to pay bills 500 times a day, ultimately 500 times a minute.

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So the regulators are faced with the horror of what happens in a business day if a major bank should fail. In short, they can no longer allow a large bank to fail because of the unending repercusions to all other banks and businesses.

To secure the safety of the system, we believe that the FDIC should guarantee without limit

1. Demand deposits
2. Wire transfers
3. Inter-bank transfers and
4. One-day federal reserve funds.

This would mean all transaction accpunt business would proceed normally, even in the event of a large bank failure.

Deductibles

Secondly, we believe that all deposits should be guaranteed 100% with a sliding scale of deductibles. In order to bring financial responsibility to the minds of the depositors, both large and small, deductibles should be started at $50,000 rather than $100,000. They could start at 10% for $50,000 and ultimately go to 20% for some higher figure. This device would allow major banks to fail -- a consequence very important for America. A major bank could fail without disrupting business, and the giant CD or note holders would bear losses beyond those of the shareholders, up to the limit of their deductible.

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Discipline

Thus with a simple solution of insuring 100% of all demand deposits and federal reserve funds and all other deposits with deductibles, we would guarantee the safety of the system, allow banks of any size to fail as they should be allowed to do, and ultimately force discipline on the banks and their shareholders, investors and depositors. That discipline would be one of prudence, forcing the depositor to learn to read balance sheets, to care about the safety of their selected bank and worry more about safety than securing top interest rates.

Last year when the savings and loan industry was suffering greatly, it expanded by more than 20% at a time when prudence would dictate it contract. Current measures by the FSLIC demanding capital ultimately will be beneficial, but true regulatory or market discipline is still in the far future. Discipline then must be introduced by depositors and investors. Not enough bank examiners are available now, nor will they ever be, to force poor managers to behave. We must rely on market forces.

Responsibility

The $100,000 coverage of deposits is clearly too high. Many savvy investors, banks and insurance companies are pleased to buy $100,000 CD's in questionable financial institutions all over the country.

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In what responsible investment can these institutions shopping for super-high rates place this money? The answer is of course "nothing responsible." So the $100,000 insurance coverage perpetrates speculative and doubtful investment actions all over the country, hurting the honest and responsible institutions and insurance funds while producing an orgy of speculation.

We are likely to see a "Gresham's Law" of bad banks develop, driving out good banks with United States government aid.

The proposal of variable rate insurance is needed with two criteria:

1. The rating of banks must be objective.
2. The punishment of higher premiums for poorly run banks and thrifts must be painful enough to elicit reform!

Capital Requirements

Both Chairman Paul Volker of the Fed and Chairman William Isaac of the FDIC have suggested that 9% is the appropriate capital level for banks. That level clearly will be destructive to the banking industry unless other competitors, including Sears Roebuck, are required to maintain 9% capital for their banking functions. Investment bankers run without comparable capital requirements. Thrifts are supposedly operating on 3% capital. All directly compete with banks. We would have no objection to the 9% capital requirements as long as all competitors have the same requirements.

Unfortunately, bank examiners look for the simplest possible way to do their job, and forcing the banks to have more capital certainly is much easier than learning to examine in depth the entire asset quality of a bank and then monitoring it.

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We believe the likes of Sears and Household Finance should be allowed into the banking business providing they operate under the same government restraints as banks. Would Sears put up 9% capital to run a bank and maintain its reserve requirements? Unfortunately people on the periphery of banking are playing the game by different rules.

Off-Balance-Sheet Liabilities

The Federal Reserve and other examiners are absolutely correct in requiring capital for off-balance-sheet liabilities. Letters of credit, interest rate swaps and other devices designed to hold down asset growth as off-balance-sheet commitments should require capital.

Foreign Deposit Insurance

The pinnacle of folly is for small banks to pay insurance premiums on all their deposits while large banks (like the Continental) pay premiums on only their domestic deposits and yet have defacto insurance on their foreign deposits. This is a great injustice to banks that do not have foreign deposits.

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Continental Bank Bail-Out

While I absolutely approve of the actions of the Administration and the regulators in bailing out the Continental, I question their current laissez faire attitude toward the Continental while it now uses the premiums made available by the banking industry to expand. The Continental, with a very questionable Camel rating, is building a 10-story banking facility in Elk Grove, Illinois with capital requirements greater than the entire deposit structure of our own competing bank. We now have a nationalized Continental Bank with unlimited ability to spend, if not taxpayers funds, the insurance reserves of their prudent competitors who didn't get themselves in trouble.

The injustices are quite apparent. While I don't believe the Continental should be liquidated, I believe that it should be shrinking continuously until its proportion of core deposits is higher than the now "Government guaranteed" hot money.

The October 7, 1985 American Banker ran a story saying that Continental plans to acquire other banks. I would, too, if I were Mr. Swearingen, whose only shareholder now is the FDIC, apparently putting no restraints on the Continental's future acquisitions. While I hope they would be viable, I find it inappropriate for the Continental to be bidding to acquire against those who have funded its rescue with FDIC funds.

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The same, of course, could be said of nationalizing S&L's and other thrifts. While not suggesting that all those in trouble should be liquidated, it could be an appropriate suggestion if we are forced to continue to subsidize our failed competition. Paying once for your competitors' blunders should be enough. We shouldn't have to re-subsidize them.

Bank Capital and Inflation

No industry in America is more vulnerable to inflation's ravages than banks and thrifts. We are limited by law to holding monetary assets: other than our buildings, furniture and fixtures, we have nothing that will rise with price increases. Indeed, all our assets' values fall with inflation. Very clearly banks cannot earn capital as fast as the Fed can print money. Every time a billion dollars is printed, the banking system is $60 million short of capital. Continuous U.S. deficit financing unquestionably will destroy the banking system as it is currently constituted.

Branch Bankings and Interstate Banking

We welcome it! We are not afraid to compete and we think we can run circles around the muscle-bound monsters.

Finance Companies Unbundling

For years, the Justice Department massaged the computer industry to unbundle software from computer sales. We have a much more competitive and vigorous market since that has been done. I fail to understand why the Justice Department allows General Motors and Ford to make new auto loans under market rates to avoid lowering their auto prices. In addition to causing great disruption to commercial financial channels, it is basically bad public policy to put a floor under auto prices through this device.

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Deregulation in General

Deregulation is beneficial because it forced us to be more competitive and to give the consumer a better shake. Everyone benefits except those who try to avoid competing. Deregulation has saved the railroad industry, revitalized the trucking and air transport industry, and should have long-term beneficial effects for the banking and thrift industries, giving the public more value for its hard-earned money. While I have no illusions that banks will ever be totally deregulated, nor should they, the results so far certainly justify the efforts.

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